



# A Federation for the 21st Century

October 2014

WITH SUPPORT FROM

# A Federation for the 21st Century

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**About this publication**

A Federation for the 21st Century

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CEDA – the Committee for Economic Development of Australia – is a national, independent, member-based organisation providing thought leadership and policy perspectives on the economic and social issues affecting Australia.

We achieve this through a rigorous and evidence-based research agenda, and forums and events that deliver lively debate and critical perspectives.

CEDA's expanding membership includes 700 of Australia's leading businesses and organisations, and leaders from a wide cross-section of industries and academia. It allows us to reach major decision makers across the private and public sectors.

CEDA is an independent not-for-profit organisation, founded in 1960 by leading Australian economist Sir Douglas Copland. Our funding comes from membership fees, events and sponsorship.

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## Foreword: Professor the Hon. Stephen Martin, Chief Executive, CEDA

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The Australian Federation has largely worked well, delivering political stability and economic prosperity for over a century. However, it can do better. Reforming the Federation has been a recurrent issue and is once again a priority on the national agenda, which is why CEDA has undertaken this timely research.

The key to ensuring our Federation is delivering responsive and efficient government has always been striking the right balance between the various functions of government.

Reliance on constitutional law and court decisions that test whether the balance is right should be minimised in a properly functioning federation.

With the Federal Government's white paper due next year, the time is right to examine appropriate responses and policies that will ensure our Federation has that balance.

This latest research from CEDA, *A Federation for the 21st Century*, examines key issues for our Federation and what can be done to improve the current structure and policy outcomes. Importantly, it examines a range of different approaches as the best outcomes will likely be achieved not by a single solution but by a combination of different approaches.

The report identifies key areas where changes such as how taxes are allocated to states could improve the delivery of core services including public transport, education, roads, health and welfare. It also describes how a range of reforms, from VET to the NDIS, have the potential to radically reshape the nature of the Federation and make it far more citizen-centric and responsive to the needs of Australians than ever before.

Another key proposal is the creation of a Federation Reform Council to monitor and evaluate the effectiveness of reforms to our Federation.

This should be an important component of any changes, not only to help ensure progress is made, but to also ensure that there are no unintended consequences of such change.

In addition, CEDA is recommending a series of Federation Conventions be held in conjunction with the white paper process to encourage the participation of as many people as possible in what must be a significant national conversation on this issue.

I hope this publication can assist in helping to start that dialogue.

Thank you to the authors and the CEDA Advisory Group for ensuring once again CEDA has delivered a quality report.

I would also like to thank our research sponsor, Australia Post, for their support, which has made this publication possible.

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## Foreword: Christine Corbett, Executive General Manager, Postal Services, Australia Post

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As Australia's oldest continually operating organisation, Australia Post has steadily expanded and evolved in parallel with Australia's national development over the past 205 years.

Prior to federation, for instance, the six colonies operated completely separate postal services that were united on 1 March 1901 to form a single Postmaster-General's Department (the PMG) under the newly formed Commonwealth.

So, the federation of Australian colonies in 1901 remains the pivotal historical moment in the creation of the national postal service that we all know today as Australia Post.

Therefore, we are delighted to have the opportunity to support this CEDA research project, *A Federation for the 21st Century*, which makes an important contribution to our national discourse.

In contemplating potential changes to our federal arrangements, this research project encourages the community to consider the ideal format for governing our nation. It also brings into sharp focus the most effective method of delivering truly citizen-centric services for all Australians.

This research is an important input into these considerations, and a vital point of reference for policymakers as they lead and respond to community views.

Australia Post is more than a passive observer in our nation's affairs and institutional arrangements. We are responsive to changes in community needs and expectations, and we are constantly seeking opportunities to provide our services in new ways. As we make the shift into the digital economy, for example, we are expanding the array of trusted services we provide via our 4400 postal outlets across Australia, as well as online.

Australia Post has always been – and will remain – a vital provider of trusted services that connect people and communities throughout Australia.

As with the Federation, the precise manner in which this purpose is discharged will inevitably continue to evolve, but our central purpose and reason for existing will not change.

## INTRODUCTION

# Approaches to reform in the Federation

## Greg Smith and Nathan Taylor



Greg Smith is an adjunct professor of economic and social policy at the Australian Catholic University. He has over 30 years' experience as an Australian economic and public policy adviser. He has played a major part in most of the major tax and superannuation reforms, and many financial system reforms, undertaken in Australia since the early 1980s. Professor Smith's career included many years as a senior executive leader in Treasury including as head of the Budget and Revenue Groups, and he was a member of the (Henry) Future Tax System review panel.



Nathan Taylor is the Chief Economist at CEDA where he is responsible for CEDA's research and policy agenda. He has developed CEDA's research programs on public policy setting, examined the issues associated with Australia's population, and developed reform agendas for Australia's macro economy and within the healthcare, energy and water sectors. Nathan has held a series of policy roles at the RBA, CCI WA, WALGA and others.

An increasing number of Australians feel that the Federation is failing them, that the coordination of the three spheres of government is rife with inertia, conflict and incapable of addressing the challenges confronting the nation.<sup>1</sup> This perspective fails to appreciate the relatively unique capacity of the Australian Constitution to foster dialogue, sometimes rancorous and sometimes consensual, and to achieve meaningful reforms, as evidenced most recently by radical expansions of the social safety net. The relative unknown nature of the Australian Constitution in the general population, compared with its US cousin, is a sign of its strength, not its weakness.

Examining Australia's Federation presents a unique opportunity, one that involves assessing the role and nature of government itself. Most public policy discussions focus on restricted aspects of government, either specific programs or the way in which government is addressing a specific problem. Rarely is the broader framework and structure of government activity evaluated. This is unfortunate because, as outlined in Chapters 4.1 and 4.2, and contrary to the perceptions of many Australians, the nation's Federation is a source of the economic success the country has enjoyed.

Research by Withers and Twomey<sup>2</sup> highlighted a range of ways in which it has benefited the nation. These include the six Cs that Terry Moran AC elaborates on in Chapter 4.2:

1. Checks on power;
2. Choice in voting options;
3. Customisation of policies;
4. Cooperation;
5. Competition; and
6. Creativity in addressing policy challenges.

These benefits are not theoretical. In Chapter 4.1, the Hon. John Brumby describes how high levels of migration out of Victoria to more economically successful states spurred policy innovation and was a major motivator for introducing reforms when he was both Treasurer and Premier.

The papers contributed to this report tell the stories of adaptation and reform in many areas of the Australian Federation. In this Introduction, the various approaches to reform are summarised and placed within a broad framework of change facing the roles of government in society. Since its foundations were laid in the late 19th Century, Australia's Federation has adapted on many fronts, including in relation to the roles of government itself. The 20th Century unfolded in ways unimagined when the Constitution was being framed, and the 21st Century already looks very likely to alter the nature of government to at least the same degree.

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## What governments do

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There are many frameworks and theories about the roles or functions of government. There are also several theories about those systems of government that have more than one level, mainly federations. In Chapter 1.2, Professor Bhajan Grewal provides a review of economic theories on the subject.

Often these ideas present what governments do as a set of 'functions' under various defined heads of power (for example, education, health services, immigration, defence), with different functions allocated to the various tiers of government. What the Australian states do in expenditure terms along these functional lines is outlined in a later section.

There is also a second way to classify what governments do, which differentiates the roles they carry out. These roles focus on different purposes for government action, delivering different outcomes. They cut across the functional divisions, though not every role is required for every function. At a conceptual level, the Commonwealth, state and territory and local tiers of government together mainly carry out four broad types of role:

1. Formulating policies and applying them through laws, regulations and enforcement;
2. Providing specific public services for individual, household or community benefit;
3. Redistributing income (or consumption), directly or indirectly; and
4. Providing channels for articulating and representing democratic voice and democratic systems for making public policy choices.

A key point to recognise is that it is quite common that, for any given function, responsibilities for these four roles can be allocated across more than one level of government. This is a key driver of entanglement in the Federation. To illustrate, consider education:

- Policy and law (such as the mandating of school attendance, or accreditation and regulation of providers) usually reside with the states;
- Specific service provision may be by states or by non-government providers, or both;
- Distributional objectives through funding models and/or student assistance may be pursued by the Commonwealth or states, or both; and
- Democratic processes will likely reflect community claims at both levels.

Whether we consider functions or roles, why do we have more than one level of government, and how should powers be allocated across them?

There are two broad ways of answering these questions, and each has major implications for the possible directions and prospects for reform in the federal system.

The first, most common, way focuses on the first three roles of government: policy, service provision and redistribution. It usually invokes a theory of functional allocation in a federation, based on the idea that some things are best done at national, and some at subnational, levels. The specific answers are based on assessments of concepts such as scale economies, spatial externalities, the principle of subsidiarity, information costs, regulatory costs, jurisdictional competition and innovation, and nationally efficient markets. Different answers may be given for the different functions of government.

While attractive for many reasons, this approach faces two main problems:

1. Different roles within a function (say distributional and service delivery) may be pursued by different (including multiple) levels of government; and
2. Many issues in practice involve interacting functions, for example, indigenous outcomes in education depend on indigenous outcomes in health, housing, justice, income support and so on. At the level of communities, or geographies, functional separations often break down in practice.

The second way to view the allocation of responsibilities is more political. This concentrates on the last of the roles of government: providing democratic voice and systems. Governments and federations are not just about 'who does what' but also about how democracy works in generating public policy decisions. Federations are relatively

modern constructs in which founders held or faced ambivalent perceptions about government itself. On the one hand, they held ideals about the possibilities of (often new) governments, while at the same time they usually did not fully trust in the ability of political systems to always deliver the outcomes they wanted. Federation provided one form of separation and decentralisation of powers, a type of insurance against unwanted capture of government by hostile interests.

This second consideration might provide a further reason why there is so much ‘entanglement’ today between the levels of government in nearly all federations. The voting public, often feeling individually powerless and remote from government, prefer two (or more) representative government voices and more than one opportunity to vote their interests, in the hope that any perceived extremes in ideology or underperformance will be thereby moderated. Thus, policy entanglement, such as overlap and duplication, which is often said to be a main problem of federations, may well be an outcome, indeed a rationale, for federations that is actually desired by many as a form of ‘political insurance’.

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## Unique features of Australian government

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Returning to the functional dimension, when the Australian Federation began in 1901, government overall was relatively much smaller than it is today – perhaps only one-third as large as a share of gross domestic product (GDP).

The nature of government radically changed during the 20th Century with the parallel development of new revenue sources (income tax and value added taxes) and new or strengthened functions, particularly the welfare state and infrastructure provision (together at times with very large military expenditures). This evolution of government is largely shared with other developed countries, but Australia has made some choices that have been different in key ways from those made elsewhere. These choices relate to the particular allocation of taxation powers, the degree of targeting of social services, and the relatively large role for non-government providers in delivering human services.

These choices and the disparate growth rates of the underlying functions have had significant implications for the Federation. They have also resulted in Australia having aggregate public spending below the average of the Organisation for Economic Co-operation and Development (OECD) countries. Australia has an almost unique retirement income system (with compulsory private superannuation and means-tested public pensions) together with large private hospital and health systems (partly funded through quasi-compulsory private hospital insurance) and a relatively large non-government school sector co-funded by governments. In addition, a wide range of other education and welfare services are provided by private or non-government organisations, with or without access to government funding support directly or through payments to clients. Economic infrastructure also is partly (and increasingly) provided through private markets, with public policy objectives met more through regulation than direct provision.

The character of the federation that has emerged in Australia partly reflects the features of this evolution. For example, the role of the non-government sectors has often been assisted mainly by Commonwealth funding policies, tax expenditures, or direct client assistance often in functional areas where there is state service provision. Where this leads to the development of markets for services, there is some shift in decision-making powers from service delivery agencies to their clients.

## What the states do now

The formation of the nation's Federation represented a formal collaboration of the self-governing colonies – which became states – of Australia. In federating, they determined a rather limited number of functions would be the preserve of the Commonwealth, with the remainder remaining in their discretion, as Professor John Cole discusses in Chapter 1.1.

The states have extensive powers, but the exercise of many of them does not necessarily carry great fiscal cost. Looking at the aggregate spending of the states and territories on the traditional functional basis, it is notable that just a few dominate the budgets (refer to Table 1).

**TABLE 1**  
**STATE AND TERRITORY GENERAL GOVERNMENT SPENDING (2012–13)**

Function	Spending (\$b)	Percentage of total state spending (%)	Commonwealth spending* (\$b)
Health	57.7	27.1	61.1
Education	52.7	24.8	29.3
Social security/Welfare	15.3	7.2	131.7
Public order and safety	21.4	10.0	3.9
Transport	23.2	10.9	5.6
All other	42.5	20.0	N/A
Total spending	212.8	100.0	N/A
Plus net new capital	11.0	N/A	N/A
Own source revenue	118.3	55.6	N/A
* Includes specific purpose transfers to the states that, when spent by them on the relevant function, are included in their spending.			

Source: ABS Government Finance Statistics, Catalogue 5512.0, May 2014.

Table 1 shows that three functions – health, education and welfare (HEW) – are together especially important in state budgets. A small part of that spending relates to policy and regulation of these sectors, but the major part is spent on service delivery essentially for the benefit of the household sector, allocated either as universal entitlements or as needs-based services. In these three areas, the Commonwealth also has a major, often larger, funding and/or service delivery role. In these areas also, private or other non-government service providers are very well established and often receive full or partial funding from the Commonwealth and states, either directly or indirectly.

To some degree, the Commonwealth and state-funded functions are substitutable. The result in considerable measure is dual, or at least parallel, service provision in the health, education and welfare sectors, with one set of services predominantly state supplied or funded and other sets largely (and often separately) Commonwealth funded.

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## Federation or economic reform

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Governments, and federations, are about more than just economic issues. However, one of the main drivers of reform proposals for federal institutions and arrangements is the contribution that it could make to economic reform.

In general, the main goals of economic reform are higher productivity and competitiveness. The economic dimensions for federation reform have several strands, including:

- Increased efficiency, mobility and competition in national markets through national or harmonised regulation, or standards, and through mutual recognition of qualifications or accreditation;
- Increased efficiency through reducing duplication and overlap in functions; and
- Improved accountability and efficiency of decisions on the supply of public goods, through seeking closer links between spending and taxing responsibilities.

Economic reform in Australia has also particularly focused on developing the role of efficient prices in resource allocation. Efficient prices can play a key role not only in competitive markets, but also in areas of market failure (such as monopoly infrastructure) and in the provision of public sector services.

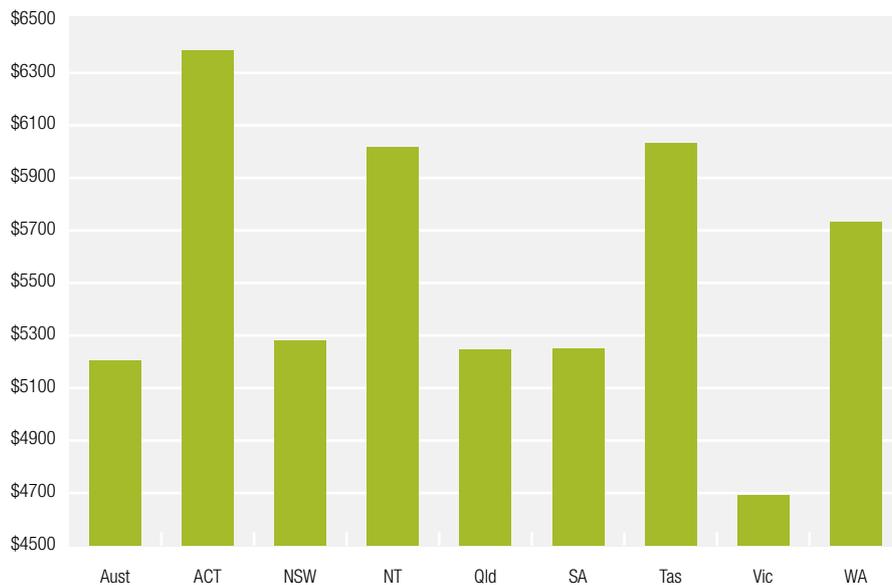
A number of public sector reform options are premised on the development of pricing or price-related mechanisms. Examples include:

- Privatisation and market development in utilities;
- Casemix funding for hospitals;
- The development of a market for disability services;
- Needs-based loadings (prices) for school funding;
- Road tolling; and
- In part, contested markets for higher education.

In the mainstream areas of government service provision, many innovations in these areas have resulted at present in a complex range of parallel systems of delivery and funding. Federal financial outcomes are often a by-product rather than direct driver of these arrangements. Equity and efficiency outcomes (in areas like health and schools) are not always straightforward as a result, and of course are strongly contested in the various fields. It is beyond the purpose of this Introduction to explore these issues in any detail, but they are noted here because they underpin a close link between any possible approaches to federation reform, particularly reform of financial arrangements, and economic reform for the delivery of services in these sectors.

Recent policy reforms, at various stages of implementation and acceptance, to health, education, National Disability Insurance Scheme and, potentially transport, illustrate the deep relationships between federation issues and economic reform issues. Professor Peter Noonan and Dr Vince FitzGerald's case study in Chapter 4.3 outlines how this has informed the transformation of the Vocational Education and Training (VET) sector, from a government supply-driven model to a customer-centric one, with public and private providers each offering services in a national training market. In Chapter 4.2, Terry Moran AC discusses the application within healthcare. All these reforms establish an efficient price for a service. This price can be varied for socioeconomic or geographic locations, and attempt to create a level playing field for providers to compete.

**FIGURE 1**  
**RECURRENT COST PER CASEMIX-ADJUSTED SEPARATION BY HOSPITAL PEER GROUP**  
**(2011–12)**



Source: Productivity Commission Report on Government Services 2014.<sup>3</sup>

In the case of healthcare, when the efficient price was introduced in Victoria in 1993, referred to as Casemix funding, it resulted in the Government paying hospitals based on the number and type of patients they saw. This approach replaced ad-hoc negotiations between the state and individual hospitals with an equitable treatment for all patients irrespective of their individual location or service provider. Setting an efficient price for a service also provides invaluable information for managers and clinicians, allowing them to identify inefficient practices and target unnecessary costs. The merit of Casemix can be proxied by comparing the cost of treatment in Victoria, which has operated the system for the longest period, with other states (refer to Figure 1).

A 2011 intergovernmental agreement would have seen the South Australian and Victorian Casemix model adopted at a national level for growth funding. After a transition period, this approach was anticipated to generate \$928 million a year in healthcare saving.<sup>4</sup> While recent Commonwealth budget decisions appear to reverse this decision, the reform has the potential to provide considerable benefits. It can be observed (refer to Table 1) that the separate funding by the states of their share of HEW markets, at an aggregate level, underlies the shortfall in their own revenues relative to their own spending (this is known as vertical fiscal imbalance). The states rely, in aggregate, on revenue transfers from the Commonwealth because they are unable to meet the service delivery costs of the HEW functions.<sup>5</sup> If instead, state service providers had the same or similar funding bases as non-government service providers, with the Commonwealth meeting the major part of the cost directly or by subsidies or assistance to clients, the current level of (indeed perhaps all) vertical fiscal imbalance would disappear.

Approaches such as these illustrate alternative role assignments cutting across functions. The Commonwealth would have primary responsibility for funding assistance, meeting distributional goals across these sectors rather than just in part. The states could retain existing HEW regulation responsibilities, as well as continue as large-scale service providers.<sup>6</sup>

Of course, whether this extension of the economic reform agenda would be a desired outcome or not, taking account of social, political, practical and other issues, remains open to differing views, and it is only one of several possible reform approaches. An outline of this and other alternative approaches is provided in the next section.

Nonetheless, this discussion illustrates the point that the reform options for federal financial arrangements fundamentally depend on decisions about how the policy, service and redistribution roles of government are organised in these main functional areas. Australia already has a wide range of models in play, with each level of government actively engaged both jointly and separately. Some services are directly provided, some are subsidised, some form part of the social transfer or tax expenditure systems, some are client reimbursed, some are universal and some are means tested.

As a result of this multiplicity of approaches, the examples of Commonwealth and state policy interfaces are very widespread, even in areas in which constitutional provisions may have otherwise appeared to have clearly separated them.

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## Alternative approaches to reform

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Jurisdictions are ‘owners of powers’ usually within a spatial context. Federations involve having more than one such owner of powers sharing the same geographic space. This is not unique to federations. Unitary states usually have more than one jurisdictional level, with some form of local government undertaking a range of functions.

A broad typology of possible reforms to a federation includes:

- Changes to the spatial structure of subnational jurisdictions. In this collection, proposals along these lines have been raised in relation to local government reform in Chapters 3.2 and 3.3. However, at the level of the Australian states there has been little interest in adjusting the numbers or borders of jurisdictions, apart from state-like self-government being conferred on the two main territories.
- Changes to the vertical allocation of roles or functions, by either:
  - Reallocating existing, largely unchanged, functions from one level to another (for example, the Commonwealth taking responsibility for aged care); or
  - Undertaking major reform to the roles or functions themselves with consequences for the Federation. In this collection, for example, the creation of a national training market (refer to Chapter 4.3).
- Changes to funding arrangements, tax powers and intergovernmental transfers, either:
  - Based on transferring existing revenue bases, such as the transfer of a portion of the income tax, to fund education in the states (refer to Chapter 4.2); or
  - As an outcome of tax reform. For example, the Goods and Services Tax (GST) reforms that abolished some state taxes and created a new basis for general revenue transfers to the states, or more extensive use of road-use charging or property tax (refer to Chapter 4.2).

This typology reflects the fact that quite different reform goals can be identified in the federation debates. Some are focused largely on concepts of jurisdiction itself, while others are more focused on broader notions of economic reform. The former pays direct attention to the allocation of powers, while the latter is directed mainly to how powers are exercised.

Several alternative approaches to reform of the Federation emerge from the collection of papers in this study. This is not to say that these approaches are all mutually exclusive. Indeed, several papers combine elements of more than one approach. The main approaches are:

1. **Federation reform as a periodic reassignment of distinct functional powers:** This approach usually emphasises the benefits of competitive federalism, both horizontal and vertical, with clearer accountability for outcomes. The allocation of functions is determined typically on the basis of subsidiarity principles embodying a range of other considerations that inform judgements about the best levels of government for different roles and functions. In some cases, the approach may argue for changes in the numbers or boundaries of jurisdictions. Sometimes the functional allocation advocated is simply to revert to the original constitutional provisions, although this is not always possible or straightforward. Aspects of this approach (although they are not limited to it) can be seen particularly in Chapters 1.2, 2.1, 3.1, 3.2 and 3.3.
2. **Federation reform as new or improved models of intergovernmental cooperation:** This approach typically sees many of the functions of government as intrinsically interwoven so that cooperation is essential for most successful outcomes. The reform issue is often cast as one of ensuring that all parties can come to the table as equals and that information and learning systems support accountability and continuous performance improvement in the delivery of agreed outcomes. This approach, in principle, does not demand any particular vertical assignment of functions be applied, but rather only that there be robust ways of coordinating the shared jurisdictional interests in them. This approach has particularly played a large part already in efforts to develop more competitive, seamless national markets. Again, several papers in this collection pay attention to this approach, including Chapters 2.2, 3.5, 4.1 and 4.4.
3. **Federation reform as reassignment of revenue bases:** The focus of this approach is vertical fiscal imbalance, either generally or in specific areas (such as transport/road funding), so the implication is generally to strengthen the relative fiscal independence of the states. The solutions here may or may not involve reform of tax bases. Usually they are constrained by the constitutional assignment of excises to the Commonwealth, which may be too difficult to overturn, so ruling out sales and consumption taxes at state level. Given the administrative advantages of national tax collection, revenue sharing arrangements have been suggested, as have systems that would give the states the right (in the personal income tax) to separately set their own tax rates. Revenue base sharing is also an issue in the interface between states and local government, as both share real property-related tax bases. In 2000, the entire net revenues of the new GST was assigned to the states in a major set of changes that combined tax and federation reform. Revenue arrangements play a major part (along with others) in Chapters 3.4 and 4.2.

4. **Federation reform as an integral outcome of an economic reform approach to government roles and functions:** A significant part of economic reform in Australia over the past 30 years has involved consequential changes to arrangements in the Federation. The motive was economic reform – increasing the efficiency and effectiveness of economic activities – rather than pursuit of a federation agenda in its own right. Some have involved the creation of competitive markets with public or private (and other non-government) suppliers, or both. Others have involved privatisation. As already noted, the development of efficient pricing in many areas of government (especially HEW and remaining infrastructure areas such as roads) may have the potential to further co-deliver economic reform and federation reform. Efficient pricing can support service models that strengthen the roles both of clients and of decentralised management of service delivery. They could lead to different role assignments in the Federation or different cooperative arrangements. Elements of these approaches are already evident in several areas (such as Casemix models for hospitals, the disability services market and so on) but these have tended to be pursued separately rather than as part of a broader or coordinated reform agenda. Chapter 4.3 is a case study of this approach, and several chapters have drawn attention to it in areas like transport and hospitals.

Examples of these four approaches have been pursued over recent years and each has supporters in this collection of papers. It is likely that all four will have a place in the complex interplay of federation developments in coming years, although the likely balance between them is not easy to predict.

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## Choosing approaches

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The task set in this research is not to provide final answers on the choice of approaches to reform of the Federation. Rather, it is to illustrate the considerable range of issues that underlie debates about the Federation and the several distinct approaches to reform that can be taken in response.

It seems unlikely that a single answer, a sweeping single solution, will resolve all issues. However, it must also be recognised that choosing any one approach, while it may meet some specified objectives, could also carry the cost of compromising other objectives. This argues for careful consideration of the issues and attention to objectives and priorities.

There are risks of unintended consequences. While the future is always uncertain, we should at least take care to fully analyse and consider any major changes that might now be proposed. The Federation, in practice, has not evolved along the lines expected by the original framers of the Constitution. Provisions intended for one purpose have come to be used for others. There is always a risk that this could apply again to any recasting of the Federation.

CEDA urges a particular emphasis on the several economic reform dimensions of federation reform.

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Endnotes

- 1 Brown, A J 2012, *Australian Constitutional Values*, November survey, accessed from: [www.griffith.edu.au/\\_\\_data/assets/pdf\\_file/0011/471719/Griffith-University-Constitutional-Values-Survey-Nov-2012-Results1-EMBARGOED.pdf](http://www.griffith.edu.au/__data/assets/pdf_file/0011/471719/Griffith-University-Constitutional-Values-Survey-Nov-2012-Results1-EMBARGOED.pdf)
- 2 Twomey, A and Withers, G 2007, 'Federalist Paper – Australia's Federal Future', *A report for the Australian Federation*, April.
- 3 Productivity Commission Report on Government Services 2014, Health, p. 10.46.  
Note: The data from different jurisdictions is not directly comparable across jurisdictions due to different accounting treatments and different population mixes. However, they do represent a proxy that, in combination with other measures, suggests Victoria operates a more efficient healthcare system.
- 4 Duckett, S and Breadon, P 2014, *Controlling costly care: a billion dollar hospital opportunity*, Grattan Institute, p. 10.
- 5 The extent of vertical fiscal imbalance varies from state to state so this observation ignores issues of horizontal fiscal capacity.
- 6 This approach would generally apply only to potentially market-type services delivered for direct household-sector benefit such as most health, education and care services but not to all HEW functions, for example regulatory policy and its enforcement, population-wide programs, and services such as child protection.

## EXECUTIVE SUMMARY

# A Federation for the 21st Century

The creation of the Australian Federation in 1901 marks the midpoint in the nation's history since colonisation. After over a century of internal peace and economic prosperity, it is important to look at the way in which Australia's governments operate and to ensure they are suitable for the new millennium. The Federal Government's *White Paper on the Reform of the Federation* is creating a rare moment of public and professional interest in the issue. This is timely as, to compete internationally and to meet the expectations of the community, Australians require governments capable of innovation, adaptation and a clear set of responsibilities for the provision of the vast range of services expected of them.

Over the course of the last century, the Federation of Australia has served the nation well. Acting as representative voices for a dispersed and increasingly diverse population, the different jurisdictions have managed to adapt to radical changes in society broadly and in government itself. When Australia federated, the size of government was a third as large as it is today. Even with this expansion, Australia has aggregate public spending below the average of the Organisation for Economic Co-operation and Development (OECD) countries. Withers and Twomey highlighted a range of ways in which Federalism has benefited the nation, and “research suggests that federalism may have increased Australia’s prosperity by \$4507 per head in 2006 and that this amount could be increased by another \$4188 or even more if Australia’s federal system were more financially decentralised”.<sup>1</sup>

Fully realising the benefits of federalism requires the different jurisdictions to be capable of acting independently, innovatively and with accountability. A number of contributions in this report identify the substantive vertical fiscal imbalance – the Commonwealth collecting the majority of the revenue and the states having the majority of the expenditure responsibilities – as a key source of dysfunction in Australia’s Federation. Yet a series of major reforms have the potential not only to radically reshape the way in which governments deliver services but also redress the worst aspects of vertical fiscal imbalance. These issues are all considered in the contributions to this study. In particular, this report:

- Outlines the historical context of Australia’s Federation, why it is still relevant to the nation and the theoretical benefits of this form of governance;
- Discusses the critical interdependencies, and assigning roles and responsibilities within a federation; and
- Outlines a series of important reform options to improve the efficiency and effectiveness of Australia’s Federation.

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## Acknowledgements

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This report has been developed with the expert input of a CEDA Advisory Group (CAG) that provided oversight of the project scope and assisted in developing the final reform recommendations. The participants in the CAG were:

- Professor Kenneth Wiltshire AO, JD Story Professor of Public Administration, the University of Queensland;
- Professor Glenn Withers AO, Professor of Economics, Crawford School of Public Policy, Australian National University;
- Professor Anne Twomey, Sydney Law School, University of Sydney;
- Associate Professor Anne Tiernan, School of Government and International Relations, Griffith Business School, Griffith University;
- Professor Greg Smith, Australian Catholic University, Chair Australian Grants Commission; and
- Professorial Fellow Terry Moran AC, National President, Institute of Public Administration Australia.

While these distinguished experts provided guidance in the creation of the report, *A Federation for the 21st Century* is entirely the responsibility of the individual authors; CEDA Chief Executive, Professor the Hon. Stephen Martin; and CEDA Chief Economist, Nathan Taylor.

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## Contributions

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### Context

To deconstruct the misconceptions that exist about Australia's Federation, Professor John Cole provides insights into the world's first peaceful formation of a continental government. *The historical context of Australia's Federation* outlines the forces at work when the Federation was formed. This would be a precursor to full nationhood, as certain aspects of modern Australia, such as a national defence force, were not deemed the responsibility of the Commonwealth but of Great Britain.

Professor Bhajan Grewal's contribution, *Economic perspectives on federalism*, describes the main theories on federalism and their consequences for assigning responsibilities. These theories extol federalism virtues, principally through maximising the ability of government to satisfy diverse preferences. The contribution notes that any constitutional assignment of responsibility is bound to evolve over time. It also observes that without strong coordinating mechanisms between the states, the role of the central government will expand. Such a coordinating mechanism does not currently effectively exist.

Australia is generally presumed to lack the cultural diversity that many other federations were formed to accommodate, for instance Switzerland where there are four national languages. In *Federalism and diversity in Australia*, Professor Nicholas Aroney outlines the second-order diversity within Australia, which is not defined by ethno-cultural concentrations but by cultural and economic measures, such as religion, types of industry, commerce and disposable wealth. This contribution tracks how this diversity has changed since federation and how these differences are becoming more pronounced with time.

Key findings:

- The federalist debate succeeded when it engaged the imagination of the broader population rather than being limited to policy elites;
- When signed, the Constitution was an agreement of its time with a range of issues considered too intractable to resolve prior to federation;
- Any constitutional arrangement of power between jurisdictions evolves over time, so there is no perfect federal structure – however, the degree of vertical fiscal imbalance drives excessive centralism in Australia, which undermines some of the positive aspects of a federation; and
- Australia's considerable diversity is not defined by ethno-cultural concentrations but by cultural and economic measures, such as religion, types of industry, commerce and disposable wealth. This diversity is growing over time.

### Critical interdependencies

While federations have the potential to bring considerable benefits over unitary governments, they also create the potential for considerable entanglement between different spheres of government. Understanding these interactions can improve the efficiency of the Federation.

In *The culture of Commonwealth and state relations*, Adjunct Senior Research Fellow Jennifer Menzies describes how the innovative potential of the Federation is not being realised because of the rancorous nature of many government interactions. The

consequence is bland policy homogenisation. This contribution identifies a key issue being the Commonwealth's role confusion and its desire to use its financial clout to force its way into areas outside its usual jurisdiction. The solution is to accept the states as the laboratories of service delivery experimentation and have the Federal Government with a role in encouraging successful innovation.

Australia's Federation has exhibited a long-running centralist trend, often abetted by High Court decisions that have underpinned a perception by the Commonwealth that it can spend money on any subject it chooses. In *The legality of federal government expenditure*, Professor Anne Twomey details the expansion of Commonwealth spending power, its consequences for a healthy federation, and the ramifications of the recent *Williams* High Court case decisions.

In *Regulatory setting within the Australian Federation*, Dr Tina Hunter describes the burden generated by regulation and how Australia's Federation exacerbates that burden. The three ways in which the states can reduce the regulatory burden they create are discussed. The contribution lays out a model for reducing regulatory overlap via the harmonisation framework that develops non-binding guidance for the states to develop their coal seam gas extraction industry.

The abolishment of the Council of Australian Governments (COAG) Reform Council ended an experiment that had put Australia at the global forefront of measuring government performance. In *Performance comparison in Australian federalism*, Professor Alan Fenna describes how the proposed reduction in specific purpose payments in 2007 resulted in a comprehensive initiative attempting to measure government performance and policy outcomes. Quantifying policy outcomes is a critical component in scrutinising how well jurisdictions deliver on their functions. However, good evaluation does not guarantee the best approaches to policy problems re-adopted.

Key findings:

- The Commonwealth is often portrayed as the saviour of the Federation, whereas its ability to drive reform is frequently just a reflection of its role as the collector of the majority of tax revenue – a more beneficial arrangement would involve the Commonwealth acting as the eyes and brains of the Federation, creating best practice policy development and encouraging adoption through funding arrangements;
- The Commonwealth was initially restricted to spending only a fraction of its own source revenue, being required to return the remainder to the states – at the time of federation it was feared that if the Commonwealth had more funds available than it required it would result in 'waste and extravagance';
- Recent High Court decisions determined that the funds raised by the Commonwealth do not belong to it, but are public funds, providing an opportunity to return to cooperative federalism;
- Australia has the legal tools to reduce the regulatory burden generated by the Federation; however, they require political will being exercised; and
- The benefits of cooperative or even competitive federalism are enhanced when the best performing policies are identified and promoted. This is a role for a central body to identify and promote good policies.

## Determining roles, responsibilities and functions

In *Criteria for assigning roles and responsibilities in the Federation*, Professor Kenneth Wiltshire explains how Australia's Founders followed the American example of separating powers between the legislature, executive and judiciary while also dividing them between the national and state governments. Again, like the American model, limited powers were attributed to the national government while the residual would reside with the states. However, the powers of the national government have grown strongly, abetted by the High Court and a pronounced vertical fiscal imbalance. This contribution outlines the history of efforts to address overlap and duplication in Australia and other comparable federations, and notes that these frequently fail. It also discusses the importance of revenue sharing when considering expenditure responsibilities.

Local government is an often-neglected sphere of Australia's government, which is unfortunate as its close community connection could enable responsive service delivery. As Professor Percy Allan AM points out in *Virtual local government*, the sector is frequently deemed administratively inefficient. Amalgamations can be perceived as a means of addressing this problem. However, beyond a very small population level, local governments do not improve their efficiency as their size increases. The reason is that the economies of scale for the services that local government deliver vary considerably and so amalgamation is a blunt instrument to drive efficiency. An alternative model is to create virtual local governments whereby local democracy can be maintained while service is adjusted to the appropriate level that captures its economies of scale.

In *The need for strong metropolitan governance within the Federation*, Lucy Hughes Turnbull AO examines Australia's current metropolitan planning governance frameworks and finds them lacking. The historic impetus for small local governments, and the failure of state governments to be able, or willing, to fill the void, has resulted in suboptimal urban planning. Addressing this deficit is critical in a post-resource boom in which future economic growth will be generated from urban centres. Already Australia's major cities generate over 80 per cent of the nation's wealth and are struggling with rapidly rising congestion and poor planning. The solution is to create discrete entities with the responsibility for urban planning.

In *Providing public infrastructure in Australia*, Bree O'Connell and Brad Vann discuss the disconnect between revenue raised for transport infrastructure and its planning and delivery within the Federation. In particular, the gap between the collection of the fuel excise and the taxes on economic activity generated by infrastructure, and the underutilisation of congestion charges and value capture result in infrastructure being under delivered. This contribution reconceptualises the challenge from the perspective of a telecommunications carrier and suggests hypothecating taxation to the jurisdiction that raises it would improve the delivery of the infrastructure.

The contribution, *Roles and responsibilities in the Federation*, by Nous Principal Tanya Smith presents a practitioner's perspective on unpicking federal entanglements. Rather than rehashing funding issues within the Federation, a more productive endeavour is to break each function of the Federation down into its constituent parts: delivery, regulation and policy. On this basis, the criteria for assessing the appropriate level of government to deal with an issue become the efficiency and effectiveness of the function. Meanwhile, a large cohort of responsibilities remains shared. However, the inefficiency can be reduced via explicitly acknowledging the elements of responsibility that reside at different levels of government and working to integrate them.

Key findings:

- Modern Australia is too complex to completely eliminate federal entanglements;
- Revenue raising capacity needs to be considered concurrently with expenditure responsibilities;
- The notion that amalgamating local governments will increase their efficiency is incorrect – they require structural change to their way of operating to achieve efficiency improvements;
- Major cities are complex systems not represented by small local governments, or state governments with a wider focus;
- The Federation fails to deliver suitable levels of transport infrastructure because of the disconnect between the revenue it generates and the expenditure responsibility for delivery, and how they are split between different spheres of government;
- To improve the functioning of local government and the major urban centres in Australia:
  - Local governments could operate as a responsive sphere of government, with the capability to deliver a wide range of services, if they adopted an efficient structure;
  - Examine the capacity of virtual local government to improve the efficiency and capability of the local government sector; and
  - Create discrete entities with the responsibility for whole-of-urban planning.

### A reform agenda

The contribution, *Reforming the Federation*, by the Hon. John Brumby describes how effectively Australia's Federation has served the nation. It includes a discussion of his personal experience with competitive and collaborative federalism. The contribution also discusses some of the challenges in the existing state of affairs, particularly the vertical fiscal imbalance. "Implementing massive cuts to the states was not the best way to start a process of federal reform, but it has precipitated a conversation we need to have about a better alignment of revenue, roles and responsibilities within the Federation". This conversation should not be just between those engaged in policy but include the broader public in the shape and nature of government for the 21st Century.

To dramatically reduce the vertical fiscal imbalance in Australia's Federation, Terry Moran AC makes a series of recommendations in *Governments, subsidiarity and saving the Federation*. These reform suggestions are based on opportunities created by recent successes in the Federation, notably the successive waves of the National Reform Agenda, which established broad, measurable, strategic outcomes for state governments and embedded the idea of devolution into service delivery in Australia.

The specific reforms suggested by Moran, which represents one approach to addressing the vertical fiscal imbalance, involve:

- Recognising the primacy of state responsibility for schooling, and the Commonwealth acknowledging this by providing a fixed portion of income tax to fund the service;
- The states developing a land tax or property charge, with a broader base of application but at a much lower rate than currently applies – the majority of the funds generated from this land tax being hypothecated to improve public transport;
- State governments extending road-use charging to existing road networks within cities which, in addition to the fuel taxes collected by the Commonwealth from specific jurisdictions, would be hypothecated to building and maintaining roads; and
- Commonwealth public service focusing on providing strategic and technical advice to government rather than on service delivery.

An alternative approach to reducing the consequences of the vertical fiscal imbalance in Australia is the policy reform (using VET as an example) described by Dr Vince FitzGerald and Professor Peter Noonan in *Case study of reform in the Federation: Vocational Education and Training*. This reform proposal dramatically shifts the focus of government service delivery from supply to a demand-driven, citizen-centric model.

The chapter describes the common elements of a number of recent initiatives in major areas of government service delivery, notably health, education and disability, which have the potential to significantly change the dynamic of Australia's Federation. They share several key themes with VET, including:

- Making government service provision more citizen-centric;
- Making the Commonwealth contribution to the price paid to a service provider nationally consistent and equitable; and
- Increasing provider accountability and transparency to create a more competitive environment.

The states retain responsibility for managing service delivery and the ability to make choices about the level of service provision they will fund. Adopting the activity-based funding model in education, as has been proposed, healthcare, as had been agreed, and in key areas of welfare, as is being implemented in the National Disability Insurance Scheme, would substantially eliminate the vertical fiscal imbalance. It would also create a basis for providing equitable and efficient service delivery throughout the nation.

Regardless what reforms are introduced to Commonwealth and state relations, there will remain activities that require coordination between the spheres of government. In *Entrenched disadvantage: Helping remote indigenous communities*, Fred Chaney AO and Professor Ian Marsh put forward a federalist innovation trialled in other jurisdictions, but not in Australia, that addresses common failings at coordinating action across jurisdictions. This innovation involves three key elements:

1. Provisional centrally determined outcomes;
2. Local agents that have the ability to implement in response to local condition; and
3. Accountability for the exercise of ability with feedback for other efforts. The contribution compares the new federalism model with how the current COAG initiatives aimed at addressing indigenous disadvantage are operating and recommends how to address holes in the response.

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## Recommendations

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Drawing on the contributions in *A Federation for the 21st Century*, there are a number of recommendations.

Firstly, to improve the operation of the Federation, it is recommended that:

- The status and governance of the COAG must be improved through:
  - Adopting a code of conduct for all participants;
  - Applying improved accountability and transparency principles for decision making; and
  - Adopting more transparent processes with a higher degree of accountability associated with them.

- A Federation Reform Council be formed to monitor and evaluate the effectiveness of reforms. The Federation Reform Council should conduct outcome-based measurements of any intergovernmental agreements to monitor performance and provide the critical insights needed for policy improvement.
- A series of Federation Conventions be held to support the white paper process and ensure the participation of as many people as possible in what is an extremely important national conversation. The federation movement did not gain traction until it went from being a conversation between the governing class to capturing the imagination of the broader population. Any grand bargain will need the buy-in of the broader Australian population to be successful.

To reduce the influence of the vertical fiscal imbalance on the Federation, Australia needs to either:

- Align revenue and expenditure requirements by:
  1. Assigning a fix portion of income tax to states for the purpose of funding schooling;
  2. State governments developing a comprehensive land tax or property charge with the majority of the funds generated by it being hypothecated to improve public transport;
  3. State governments extending road-use charging, and receiving the fuel taxes collected by the Commonwealth, to be hypothecated to building and maintaining roads; and
  4. The Commonwealth focusing on providing strategic and technical advice rather than on service delivery; or
- Extend the activity-based funding reforms to cover health, education and welfare.

To address areas of inevitable federal entanglement, Australia should adopt a new framework for coordinating federal and state relationships based on:

- Provisional centrally determined outcomes;
- Local agents who have the ability to implement in response to local condition; and
- Accountability for the exercise of ability with feedback for other efforts.

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#### Endnotes

- 1 Twomey, A and Withers, G 2007, 'Federalist Paper – Australia's Federal Future', *A report for the Australian Federation*, April, p. 5.

SECTION

1.0

# Context

- 1.1 The historical context of Australia's Federation  
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# 1.1

## The historical context of Australia's Federation

### Professor John Cole



Professor John Cole is Executive Director of the Institute for Resilient Regions at the University of Southern Queensland (USQ). He has been a long-time adviser and innovation leader in sustainable development here and overseas, with senior appointments in government, industry, NGOs and academia. He has been awarded the Queensland Premier's Award for Leadership in Sustainability and was recently appointed as a member of the council charged with stewarding the 30-year Queensland Plan. An alumnus of the US Government's International Visitor Program (1999), Professor Cole has a PhD in demographic history and is also an Honorary Professor at the UQ Business School.

Ask Australians what is celebrated on 1 January and they will inevitably answer “New Year’s Day”. Remember anyone ever celebrating Federation Day? Low-key jubilee events marked the 50th anniversary of federation in the relatively austere post-war period. Centennial celebrations in the more prosperous times of 2001 had to compete with the crowning glories of the 2000 Sydney Olympics. Federation has never had a hold on the Australian imagination like Anzac Day or even Australia Day. Curiously, for something that former New South Wales (NSW) Premier Nick Greiner described rightly as “fundamental to the quality of life of Australian citizens”,<sup>1</sup> we seem uninterested and unengaged.

Backyard barbecue conversations about our federal system of government are inevitably dismissive and absolute in their remedy, reflecting a unitary or centralist perspective on government. As the republican debate charged up in the early 1990s, Professor Greg Craven described the federal Founders’ place in the national lore as being “prominent only in the degree of their obscurity”.<sup>2</sup> The same is true today because beyond the parliamentary precincts of our capital cities, public engagement with our constitutional processes remains almost non-existent.

The *vox populi* on how to fix our federal system reflects discordance between public perceptions of how we are governed and the various traditions that underpin the federal principles of Australia’s constitutional arrangement – “a constitutional schizophrenia”, as Professor A J Brown called it.<sup>3</sup> The illusionary invisibility of the Federal Constitution in the everyday life of the people possibly explains the common misconceptions we have about our federal system of government.

Former Governor General and High Court Justice, Sir Ninian Stephen, once mused about federalism: if judged by “the lack of any reaction to it”, perhaps “we should conclude that it is generally regarded as an acceptable enough structure of government [that] does not present any major problem for any concerned sector of society”.<sup>4</sup> No one beyond the political class it seems is sufficiently aggrieved by the performance of our Federation to agitate for serious reform.

For most of its history, Federation did not even mean independence from Britain. Not that Australians of any political persuasion were rushing to gain independence. It took the threat of Japanese invasion in 1942 and a reorientation of Australian security policy away from Britain towards the United States (US) before the Curtin Government belatedly ratified the 1931 *Statute of Westminster* conferring Dominion autonomy. The post-war influx of non-British migrants had already started in 1948 when the Chifley Government made Australian citizenship a formality through the *Nationality and Citizenship Act*. The Australian flag with the Union Jack in the top-left corner first flew in September 1901, but it would be 1953 before the Menzies Government, through the *Flags Act*, proclaimed the blue ensign our national flag. The Hon. Bob Hawke was Prime Minister when, in the 1980s, the last formal ties were severed with Britain.

In the 1950s, Russel Ward wrote a history of Australia, noting that the legends colouring the national character were built from “a people’s view of itself”, their experience, values and behaviour.<sup>5</sup> These attributes could feed and sustain “an invented but vital myth”, which Inga Clendinnen found strong enough to “bind a person to the nation and the national culture”.<sup>6</sup> In the case of the Federation, regrettably myths have figured not to bolster but to diminish the Founders’ accomplishment and obscure the central role that federalism has played in the Australian democracy, nation and culture. Professor Donald Horne called its framing a “desultory” process that left Australia with a phony “nationhood” seemingly marred by an absence of “struggle” in its making.<sup>7</sup> Some credence is given to his view by the low voter turnout in the plebiscites of 1899–1900, which reportedly many approached “unenthusiastically”.<sup>8</sup> In none of the plebiscites

that led to the passage of the *Commonwealth of Australia Act* through the British House of Commons in 1900 did a majority of eligible colonists venture to the ballot box to vote ‘yes’.

In the absence of a strong collective sense of our history, the meaning and significance of the federal achievement has been easily diluted and apt to be manipulated politically. Federation has become confused with nationhood, for example, when it was a step towards, not the realisation of, the other. Prime Minister Paul Keating would have had people believe differently in 1993 when he argued for an Australian Republic invoking the Federal Constitution as if it was the key to reshaping national identity. “It’s hardly radical”, he said, “to suggest that our Constitution should be remade to reflect our national values and aspirations, evoke pride in our heritage and confidence in our future, and help us unite as a nation”. As to the fate of the Federation, he admitted that he did not believe that the states “could be easily abolished even if the nation thought it worth doing”.<sup>9</sup>

Labor leaders have traditionally downplayed the importance of the Federation, or at least the states’ part of it, which many have wanted to abolish. In 1957, Gough Whitlam lamented Labor being “handicapped ... by a Constitution, framed in such a way as to make it difficult to carry out our Labor objectives”.<sup>10</sup> Half a century later and conservative leaders were joining the chorus of ruminations chewing over alternatives to the current constitutional framework.

In 2005, Prime Minister John Howard spoke the political code of an unreconstructed centralist when he pointed to changes that had brought “a greater focus by the Australian people on ties to nation and to local community, and less on traditional state loyalties”.<sup>11</sup> His opponent, Kevin Rudd, won the 2007 election promising a “cooperative” federalism but he declared, too, there would be “no turning back” to earlier forms of federal arrangement. Rudd’s prediction proved correct, as did his observation on the need to “make our current arrangement more workable, more rational and less dysfunctional”.<sup>12</sup>

For most Australians, nuanced distinction between ‘federation’ and ‘nation’ is immaterial and largely irrelevant. If there is such a thing as ‘federal sentiment’ today, it resonates closely to Australian nationalism and, as an historian wrote for an earlier generation, it has little to do with any “preoccupation with or conviction about the constitutional and political principles of federal government”.<sup>13</sup> Over time, Australians have written their own story of nationhood, repudiating the shibboleths of an earlier era while drawing on sources of inspiration as varied as the sacrifices at Gallipoli and the ANZACs, mateship and a fair go, respect for multiculturalism, and more recently, reconciliation with the original peoples of Australia. But lost in the telling of this story is the importance of our Federation. The obfuscation of our history to favour the unitary and centralised tradition of government has seen several generations of Australians tilting at constitutional windmills, chasing symbolic second-order issues while leaving the crucial matters that determine our quality of life. Correcting this deficiency in the public perception of federation is essential if the third age of reform is to deliver the improvements our federal system so obviously needs.

## Drivers of federation

Working the hustings at Ashfield in 1897, federalist leader Sir Edmund Barton put the proposition simply and famously: “For the first time in history we have a nation for a continent, and a continent for a nation.”<sup>14</sup> Just three years before he became Australia’s first Prime Minister, Barton defined federation and nationhood as a singularity. It would be an idea that was to be inviolable, indivisible and continental in scale. An ambition that was long in the dreaming and even longer in the making, federation has evolved to this day as the cornerstone of government in Australia.

From the 1840s, successive British governments consistently encouraged self-government for their Australian possessions, preferring initially a unitary decentralised model instead of sovereign separateness for each colony.<sup>15</sup> But there was little to hasten colonial progress on the prospect of a federation. Across the Pacific, an American vision of ‘Manifest Destiny’ was being realised in the ever-westward frontier expansion of white settlement. Here our national dreams were less grand, reflective of a small population on a massive land, extending to the basics of railways, ports and roads – connecting the coastal cities to their catchment hinterlands but not necessarily to each other.

Support for the national idea would not transcend the contrariness of colonial self-interest, or the political inertia of the people themselves.<sup>16</sup> The tipping point for change came mid-way through the 1890s when, as Vance Palmer wrote, “the genius of this young country had a brief but brilliant first flowering”.<sup>17</sup> The changing demographics of Australia in the 1890s was a key contributor to the ‘cultural forces’ that animated a nascent nationalism and first steps of separation from Britain – without relinquishing membership of the British Empire or even British nationality.<sup>18</sup> For the first time since the gold rushes of the 1850s, more than three-quarters of Australians were locally born.

From it all, a new generation of leaders emerged with the savvy to ensure the federation idea transcended the turbulent politics of the time. Grassroots support was mobilised through politically directed campaigns by movements such as Alfred Deakin’s Australian Natives Association and Sir Edmund Barton’s Australian Federation League. These groups stoked an emergent national consciousness in the two major states of Victoria and NSW. Some have called it the “nation’s first great political communication campaign”.<sup>19</sup> The outcome was a negotiated national consensus strong enough for all the colonies to accede to diminished power and prerogative. Although, as Alfred Deakin would later recall, they did so with “thought or hope of gain”<sup>20</sup> through the payback of a federal compact.

The great distances and degree of separateness of the six colonies as well as the diversity of their economic interests should not be underestimated in mitigating the chances of an easy political integration. Had not the colonies federated as states within the Commonwealth in 1901, their very different development trajectories later quite possibly would have lessened the prospect of a union, especially Queensland and Western Australia (WA). As it was, both these large outlying resource-rich states were to join a federation that essentially had already happened. Geoffrey Blainey rightly called the “coming together of the six Australian colonies in 1901” as having “a touch of the miraculous” about it.<sup>21</sup>

## Security

Difficulties and barriers notwithstanding, as the 19th Century neared its close, there were many good reasons for the six British Australian colonies to form a federation – starting with what Roger Wilkins termed “geography and historical accident”.<sup>22</sup> The imperial rivalries of the European powers provided the initial push for federation in the early 1880s when a great deal of local insecurity arose from French and German incursions into neighbouring Melanesia. They left no doubt that the South Pacific was not off limits to further colonialism. Besides these broader regional threats arising from Britain’s longstanding strategic rivals, public alarm was voiced periodically about the threat of the ‘yellow hordes’ to the north. Then, as now, border security was an issue for Australians, and inter-colonial cooperation aimed at restricting Chinese immigration would in time be the precursor to the first Commonwealth Parliament’s White Australia policy.

Living at the farthest end of the European world and far from each other in a large undeveloped land, purportedly protected by the global reach of the Royal Navy and the prestige of membership of the British Empire, local colonists still found reason to be uneasy about their security. The British military posture in the Pacific had been diminishing since 1870 and the need for great self-reliance was confirmed in 1887 by a visiting British adviser to the Victorian Government. Major General J B Edwards called for “the federation of the military forces of the Colonies,” a “common Defence Act” and an increase in defence expenditure.<sup>23</sup> It was enough for Sir Henry Parkes, speaking at Tenterfield in May 1889, to restate his support for the federal cause. He called on his fellow colonial leaders “to set about creating this great national Government for all Australia ... to better preserve the security and integrity of these colonies”.

## Breaking down barriers

Beyond concerns of security and defence, arguments in favour of federation were propelled by a growing demand to break down local barriers to trade and commerce in favour of a common market. Isolated regional economies dotted the continent, loosely linked by rail networks that had developed inland from the ports to serve individual hinterland catchments and constituencies.<sup>25</sup> Travel from one part of the country to another inevitably involved changing modes of transport several times. In 1883, when rail connected the two main cities of Sydney and Melbourne, they were still 18 hours, different rail gauges and a customs post apart. A thriving coastal shipping sector provided the main transport for industry. The capital cities and provincial ports were the transport hubs of regional commerce dotting the coastline from Townsville in the north to Albany in the west.

In the early 1880s, Britain dominated Australian colonial trade, accounting for 75 per cent of its commerce.<sup>26</sup> Over the next two decades however, investment in local manufacturing and gradual improvement in connecting communications and infrastructure resulted in growth in inter-colonial trade to outstrip that of Britain. As internal trade grew, so too did business interest in a common national market that would be stimulated by the removal of internal customs and tariffs. By 1901, trade between the colonies amounted to £55 million or 39 per cent of total trading activity.<sup>27</sup>

The financial and commercial collapses of the early 1890s and consequent privations of economic depression provided a sobering reminder of the need to strengthen local resilience by expanding the economy across colonial boundaries. London bankers were also clear in their message that credit would only flow again to Australia once there was a federal government and national economy. These demands for a national

playing field for banking, finance and commerce would underpin later broad acceptance of the primacy of Commonwealth law over state laws, and concurrency for the federal system in matters relating to bankruptcy and insolvency.

Achieving a common national market that benefited all sections without unduly harming any particular constituency was impossible. So it was the main question dominating debate in the lead up to the final plebiscites in 1899 and 1900. The federalism-as-economics argument cuts both ways. By the end of the decade “arguments against union in the prescribed terms consisted almost entirely of hard-headed special economic pleading”.<sup>28</sup>

The core economic debate about federation occurred between, on the one hand, the agriculturalists and miners who shared the imperial preference for free trade; and on the other, the industrial protectionists who were largely comprised of manufacturers from Brisbane, Melbourne and Adelaide. Their shared fear was the reasserted commercial dominance of NSW and Sydney. Free trade was to win out in the federation deal, but only as it affected trade between the states. After 1901, the barriers were uniformly applied against overseas products and services, and protectionism was to be a feature of Australian government economic policy for most of the 20th Century.<sup>29</sup>

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## Voting on federation

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Where colonialists lived and what they did for a living strongly predicted how they voted on federation – if they voted at all. For regions like the Riverina and northern NSW, where regional economies and communities were bifurcated by colonial boundaries, federation meant an end to the daily intrusion of bureaucracy through customs and excise imports. Some even dreamed of a national railway system without competing differential freight rates. Not surprisingly, the various regional views on federation reflected how locals saw it serving or threatening their economic interests. In Toowoomba and the Lockyer Valley in southern Queensland, small farming communities fiercely resisted the federalist cause, believing they would lose their metropolitan markets to competition from the south. Brisbane manufacturers felt the same about Melbourne factories.

Further north, those in northern and central Queensland, frustrated at the poor level of government from Brisbane and wanting the benefits of national markets, saw a federal government as an improvement. Many still dreamed also of one day breaking away from Brisbane. With these regional divisions, the ‘yes’ vote in Queensland just scraped through by the barest margin.

In WA, it was a similar story of division between sectoral interests. The old rural families voted to stay out while the newly arrived gold miners voted like their home states back east. The WA Government worried about a loss of customs revenue and all the smaller states wondered at being dominated by NSW and Victoria.

Tasmania, Victoria and South Australia (SA) all recorded more than two-third majority ‘yes’ votes. In NSW, the vote was always near evenly divided because, as the most populous and oldest state, it had most to gain and lose – to win as a centre of trade and commerce, to lose because it would pay most for federal expenditures.

How persuasive the business interest was in carrying the federation cause is difficult to assess. Historian Brian de Garis rightly noted that “crucial though it is, microeconomic reform makes a poor rallying cry for nation-builders”.<sup>30</sup>

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## Closing the federal deal

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By the 1890s, the federal idea was already well practised and the Australian colonists could look no further than the US and more recently Canada for inspiration and lessons about how best to structure a system of national governance covering vast expanses of territory, different regional economies and diverse populations.

### The first constitutional convention

In March 1891, the first constitutional convention came together in Sydney at the invitation of Premier Parkes. Leading agents of the smaller states, including Queensland's Sir Samuel Griffith, Tasmania's Inglis Clark and SA's Charles Kingston, produced a working draft upon which nearly a decade of debate would build. It was a draft agreement between contracting parties, a conservative legalistic document inspired by the American example of constitutionally defined checks and balances but embracing also the Westminster model of responsible government. The British-sourced inspiration brought with it the inherent ambiguities attached to the role of the Crown, the primacy of the House of Commons within the Parliament and the obligations of ministerial accountability to Parliament – all based on recourse to tradition, tacit convention and common law.

More socially homogenous and self-assured in their cultural identity and British heritage than their north American compatriots, Australians took a narrower approach to considering and defining the point of federation, at least as it would eventually appear in the Federal Constitution. Missing was any acknowledgement of the indigenous peoples or mention of human rights, statements of philosophic principle or self-evident truths. Instead, practical sentiment couched the utilitarian arguments for and against the federal concept. This can be explained by the crucial early agitation for a national parliament coming not from the governed but the governing class – the colonial politicians and business leaders who could see a bigger picture, a larger commercial opportunity in larger markets, uniform laws and a stronger system of national defence.

In the broad history of Australian federation, the 1891 convention remains important because it was then that both the reasoning for, and the actual scope of, federal power was established. Besides agreeing that trade and commerce between the states should be “absolutely free”, the colonial delegates readily identified the functions to be assumed exclusively by a federal government, which became section 51 of the Constitution. These included exclusive responsibility for:

- Customs and tariffs;
- Monetary affairs and currency;
- External relations and defence;
- Posts and telegraphs (communications);
- Banking and insurance;
- Marriage;
- Copyrights and patents;
- Company law; and
- Maritime and immigration.

Responsibility for quarantine was to be the single health function assumed by the Commonwealth. The proposed federal government would also enjoy concurrent powers of taxation with the states. With the jurisdictional content of federation agreed, the 1891 convention also restricted membership of the future Commonwealth to just

the existing Australasian colonies, including New Zealand. States could be created in future but only in the very unlikely event of the agreement of the majority of voters in the affected existing state(s) and the Commonwealth Parliament.

The 1891 convention was a false dawn. Momentum for a federation quickly died for want of public interest as the 1890s descended into “one of the most troubled decades of Australian history [when] political fears and passions were stirred by financial and industrial strife and deepened by the economic problems of drought”.<sup>31</sup>

### Relaunching the debate

Not until signs of economic recovery appeared and colonial politics stabilised relatively in 1894 was NSW Premier George Reid able to respond to the urgings of the federalists and relaunch the issue, albeit this time on a platform that would involve the electorate beyond the political class. Much has been made of the grassroots revival of support for federation arising from meetings at Corowa in 1893 and Bathurst in 1896 that served as platforms for civic nationalist movements like the Australian Natives Association and the Australian Federation Association. They were important protagonists for the cause, keeping the federation flame alight in good years and bad, mainly in south-eastern Australia and particularly among the border communities along the Murray River.

Politics was changing as was public expectation in the role of governments. By 1895 it was clear to the colonial leadership that something so fundamental in the democratic governance of a country could not happen without the involvement of the general population. But to workers focused on organising unions, improving their parliamentary representation and achieving better working conditions, federation was a side issue they saw as serving the interests of the employer and propertied classes. For the small minority of republicans, the federalists were voices drowning out the more revolutionary idea of a break from the monarchy and Britain. An early historian of federation rightly concluded that overall “among the politically active minorities in the Australian community federation ... was supported by centre or liberal groups, and by moderate conservative and labour leaders; and it was opposed by both extremes of political opinion”.<sup>32</sup> Like many of the other major themes of the time, federation brought into focus questions about the role and size of government and what could be expected by the specialisations that multiple levels of government afforded.

For almost a year from March 1897 to March 1898, the second National Australasian Convention was to conduct its business in Adelaide, Sydney and Melbourne. This time, popularly elected delegates convened to develop a federation model that would “enlarge the powers of self-government of the people of Australia”. But with nearly 70 per cent of the population living in NSW and Victoria, the actual allocation of electoral power and the reconciliation of federal and democratic principles were to prove problematic for the convention. Fortunately for the federal movement, Queensland was not represented in either meeting, being preoccupied with dealing with its own northern secessionists. Had the Queenslanders with their well-known penchant for states’ rights been present, it is unlikely that a draft Constitution Bill and a national plebiscite on the question would have been achieved.

Two issues dominated the convention debates on how to achieve a workable federation:

1. The rights of the states as reflected in the powers of the Senate; and
2. The structure of public finance and taxation once the Commonwealth was established.

Deakin was later to assess that the federal idea was “given a decidedly more democratic” basis in 1897 by provision being made for both Houses of Parliament to be popularly elected, albeit the Senate on the basis of an equal state allocation.<sup>33</sup>

Orthodoxy had it that the Senate was to be elected and work to protect the power and interests of the states as a party to the federal contract. An historical miscalculation of major significance, the notion had been questioned back at the 1891 convention by Queensland delegate John Macrossan. He’d rightly predicted that, “The influence of party will remain much the same as it is now, and instead of members of the Senate voting, as has been suggested, as states, they will vote as members of parties to which they belong”.<sup>34</sup>

By 1897, Alfred Deakin had formed the same conclusion that the Senate being held hostage to the whims of the smaller states was a fear already made obsolete by the discipline of party politics.<sup>35</sup> People and politics, not states, would be the denominator in the Senate as much as the House of Representatives.

And yet, with the convention being comprised so overwhelmingly of the leadership of the various colonies, on the question of Senate powers and its ability to frustrate and deny the will of the House of Representatives, the delegates simply could not abandon their state inhibitions. The federalist spirit was not yet creative enough as to conceive of a workable mechanism for breaking deadlocks between the House of Representatives and the Senate. NSW was already counting the costs, foreseeing the cross-subsidies to the smaller, poorer colonies. The prospect of the small states having powers within the federation that extended well beyond their capacity to contribute financially was almost a deal breaker for NSW.

A follow-up meeting of the Premiers early in 1899 was needed to resolve the deadlock issue. They resolved that in cases of deadlock between the two houses of Parliament, following dissolution of both houses, the will of the people would be asserted by simple majority support for the passage of a Bill in a joint sitting of the House of Representatives and the Senate. The Senate was to have equal power with the House of Representatives in every respect except it could reject but not amend or initiate money Bills, and not amend Bills to initiate taxation or increase charges.

In the rather rushed wrap-up to the convention in March 1898, delegates bundled a range of intractable issues for short discussion, and included additional Commonwealth functions in industrial conciliation and arbitration. The Constitution once again provided for a federal supreme or High Court. Some topics, such as the regulation of the waters of the Murray-Darling Basin, were dealt with abstractly to get them across the line, with every expectation that they would be unpacked again after federation. A decade earlier, Barton had learned from the wily Parkes that some issues like tariffs would be best left to a Federal Parliament or there would never be a federation.

So it was that the most important foundation of federation was not completed through the convention process but was consigned to future governments for resolution. A big question it was. How to secure a sustainable and equitable financial basis and recurrent funding formula for the federal arrangement? With the new Commonwealth Government set to assume responsibility for the customs function from which the states derived most of their tax income, what would be their future? Manning Clark reported the delegates’ dilemma, anticipating the later issues of vertical fiscal imbalance and horizontal equalisation:

“If the Federal Parliament were empowered to levy customs duties, what sources of revenue would be left to the colonial parliaments? If the Federal Government had a surplus revenue, on what principles would that surplus be divided between the six colonial governments? Would it be by population, or by area, or by financial need?”<sup>36</sup>

The answers would not come before 1901. To secure the compact, Tasmanian Premier Edward Braddon provided a way forwards by coming up with a ‘holding pattern’ strategy. To be ever known as ‘Braddon Blot’, this decision by the convention actually confirmed the states’ dependency on the Federal Government from the start, and marked the birth of the vertical fiscal imbalance. For the first 10 years of the Commonwealth, the Federal Government was not to spend more than 25 per cent of customs and excise revenue, and it was to repatriate the remainder back to the states. Other financial assistance could be provided by the Commonwealth “on such terms and conditions as the Parliament thinks fit”.

Before the expiration of this provision at the end of 1910, the Commonwealth and states would have to work out a new deal. The deal was done, but the federal arrangement was incomplete in several crucial respects – to the later detriment of the Australian people.

### Shaping Australian federalism

In a world different to the real one, perhaps the Founders could have better seen that their creation would in time contribute to an erosion of state powers and autonomy, dominance by the Commonwealth, and a deteriorating imbalance of sovereignty and fiscal efficiency. In this respect, the demands of a negotiated consensus in 1899–1900 led them to several major miscalculations that have shaped Australian federalism and will be difficult to correct without broad community support for reform – on the magnitude almost of the establishment of the Federation itself.

The key sources of dysfunction that can be traced back to the Founders are:

- The denial of regional democracy and growth of the Federation; and
- The absence of a sustainable federal financial framework.

The most basic miscalculation by the framers of the Constitution was to believe that the Senate would protect the constitutional integrity of the Federation by being a bastion for states’ rights and powers. It simply never happened. The Senate issue was significant because it distracted delegates from the more important challenge of how to sustain and grow the Federation. To this end, a fundamental design fault in the Federation was its stillborn territorial shape, clinging as it does to boundaries devised in London more than 150 years ago.

By turning its back on the creation of new states, Geoffrey Blainey rightly saw that Australia had missed “one of the advantages of federalism”.<sup>38</sup> Instead, the Founders and their successors as state leaders consigned regional Australia to “a frozen territorial structure which is widely regarded as delivering neither the level of national unity nor the serious political decentralisation which many Australians have long desired”.<sup>39</sup>

In the current era of cost shifting between levels of government, the need for “better regional governance arrangements” is an oft made plea by the local government sector.<sup>40</sup> But regional development authorities and larger local authorities have little chance of bringing development integrity to their part of Australia so long as they lack the sovereignty that comes with statehood. And their chances of improved resourcing would be more likely achieved by the restoration of a stronger financial basis to the states than by some oblique reference to the merits of local government in the Constitution.

The other great continental federal democracies, the US and Canada, increased their number of states over time, in the process ensuring their federations more closely reflected the interests and needs of the regions. If the principle of subsidiarity is to count for anything then separation and creation of new states has to be part of the

federal reform process and core to a regional development strategy that has regions at its core. This may become a vital consideration given the spread of Australia's natural resources, climate change adaptation strategies, future settlement patterns and the likely focus of development ahead.

It is difficult to see how the boundaries of a federation for the 21st Century can be recast to more closely account for regional identity and development if all the players – including Commonwealth, states and territories – are not prepared to create more representative states. Certainly the governments of Queensland and WA have little incentive in the current federal setting to carve off their royalties-earning resource-rich mining regions far removed from the major population and cost centres in the south of both states.

The biggest critical lapse on the part of the Founders was their failure to enshrine a sustainable basis to the financing of the Federation. The creeping encroachment of the Commonwealth on state functions over the past 80 years has been a complex process, but at its core, it has been the flawed financial model of federation. Governments of neither persuasion have sought to revisit the constitutional basis of the problem. Both sides of politics have sponsored reforms that have contributed to the massive expansion of the Commonwealth beyond its core areas of sovereignty commissioned in 1900.

The problem was rooted in the minimalist expectations of the Founders in which so little was done to amend state government functions, while rather blithely they were stripped of their main source of revenue. In 1900, it was inconceivable that the proposed Commonwealth would become more powerful than the states. Even as some of the colonies were introducing progressive income and land taxes to boost their revenues, few convention delegates blanched at the granting of concurrent powers of taxation to the Commonwealth. In an era of minimal government and taxes, it was not a big deal. After all, total taxation of all levels of government as a proportion of gross domestic product (GDP) in 1901 was only five per cent – compared with 23 per cent for the Commonwealth and four per cent for the states today.<sup>41</sup>

The unwitting upshot was a flawed constitutional model delivering a fiscal imbalance that would require the parties to the federal contract to periodically negotiate new bridging funding for the states. In the continuing absence of an agreed constitutional basis to taxation and public revenues, that fundamental shortcoming of the Federation now defines the shape of public policy in just about every field of government. It explains why today total Commonwealth funding to the states amounts to nearly one-quarter of the Federal Budget and 40 per cent of state revenue. Commonwealth involvement intrudes into every aspect of the affairs of state and territory governments in contractual arrangements, such as the 144 National Partnership Agreements, which were meant to enshrine 'cooperative federalism'.

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## Back to the future? A federation for the 21st Century

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It's all a far cry from what the Founders of Federation thought they were launching on 1 January 1901. The perverse anti-federal outcomes are now so obvious as to arouse a broad spectrum of complaint preparatory to proving the case for reform. The Federation has become, for Professor Ross Garnaut, "the worst of all possible worlds" where the "states do not have the fiscal freedom ... to deliver the potential benefits of Federation ... and the Commonwealth does not have the capacities for effective central exercise of the powers of government".<sup>42</sup>

Veteran political commentator, Laurie Oakes, damns the federal compact as a “mess” and points to Prime Minister Tony Abbott complaining of the “dog’s breakfast of [overlapping] responsibilities” between federal and state governments.<sup>43</sup> Treasurer Joe Hockey anticipates the Commonwealth withdrawing from service delivery: “We’ve got to sort out the Federation ... Canberra is a long way from the services – we are not good at it”.<sup>44</sup> Former NSW Premier Nick Greiner is more embracing of broad reform, declaring that the “present, multifaceted, wasteful, ineffective shambles that passes for federalism should [not] be the Australian way for the 21st Century and beyond”.<sup>45</sup> Leading sections of the media are calling for “a vigorous national debate on the role of federal and state governments”.<sup>46</sup> It all sounds reminiscent of a constitutional convention back in 1898, including the quiet profile of the Labor Party on the issue.

At the centenary of Federation, an opportunity was missed to revisit the founding propositions, and as a nation to consider how best to ensure the federal arrangement remained valuable and relevant in the lives of Australians. For Australia to make the most of the future and realise the great promise of its human, economic and natural capital, a new age of reform is needed with an agenda broadly informed by its people. To be vital and relevant, Australia’s next and third age of reform must embrace the crucial defining themes of the 21st Century, but also build on the achievements of its history.

The next age of Australian reform will need to be more than an ideas weekend in Canberra; it will take some years and maybe even several terms of government to crystallise the essence of the agenda into a broad consensually supported mandate. But it can be done. Australia has braced through challenging times before during which it has digested major, sometimes unpalatable, reforms and emerged stronger, more unified and more competitive. Two previous reformist eras have delivered the Australia of today – the latest as recently as 1983 to 2000, the age of economic liberalisation, when the Hawke-Keating-Howard governments dismantled the old edifices of a heavily regulated and protected economy, and opened Australia to the world.

A hundred years earlier, the first age of Australian reform was even more auspicious. The Australians of that era rose to the challenge of ending the colonial paradigm, plying instead the long road to federation, the beginnings of nationhood, and the making of the Australian Constitution and with it the realisation of the Commonwealth of Australia. Much of the subsequent history of Australia during the 20th Century owes to the fact of Federation – making it the most important Australian reform of all.

The great political accomplishment of the Australians of the 1890s was to see that reform and national invigoration on the big issues was neither unprecedented nor impossible. Ultimately, if there is a legend to be built from Federation that can bind people to its cause as an instrument of Australian democracy, such inspiration will be found in Corowa where the governed of Australia first told the governing class, that the big defining decisions about ourselves as a people cannot be made by anyone but the people. The challenge now is to bring the people positively to the discussion.

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## 1.2

# Economic perspectives on federalism

## Professor Bhajan Grewal



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The purpose of this chapter is two-fold: to outline economic concepts, principles and theories about decentralisation and federalism; and to draw lessons for the future of Australian federalism.

The presumption in doing so is not that every federation must follow the same theoretical prescriptions so that all federations have identical patterns of assignment of functions. It is natural for each country to design its own assignment pattern reflecting its historical, cultural, economic and social circumstances. The expectation, however, is that in fashioning its assignment patterns, each country should be guided by certain fundamental principles and rules so that its chosen assignment pattern has internal coherence and integrity.

Five different economic perspectives reflect the prevalent conceptions of the structure of the public sector in a federation:

1. The public goods perspective;
2. The organisational costs perspective;
3. The public choice perspective;
4. The market preserving federalism perspective; and
5. The incomplete contracts perspective.

Together, these perspectives have helped identify, analyse and popularise (in recent years through the international agencies, such as the World Bank and the International Monetary Fund) the virtues of fiscal decentralisation.

The public goods perspective on federalism focuses on determining the most efficient organisation of the public sector by matching the governance structures with the benefit spans of different public goods; local public goods are assigned to local governments, state public goods to state governments and national public goods to national governments. This so-called principle of fiscal equivalence (between governance structures and public goods provision) will also uphold the principle of subsidiarity because the only public goods assigned to the national government are those that cannot be efficiently provided by the subnational governments. Such fiscal equivalence between the two hierarchies (of levels of governments and public goods) is considered to improve allocative efficiency of the public sector.

The organisational costs perspective aims to assign responsibilities in such a way that total organisational costs of the public sector are minimised. Indeed, it is suggested as part of this theory that constituent assemblies should be established to monitor the organisational costs and to undertake periodic reassignment of functions between levels of government when warranted by the changing nature of people's preferences or technologies for producing or providing certain public goods. The organisational costs theory acknowledged, for the first time in economics literature, that assignment patterns of federalism need to be monitored and evaluated because they are dynamic and likely to change in response to economic and technological developments.

The public choice perspective is based on the premise that in the absence of appropriate institutional constraints, the natural tendency of a government is to use its monopoly over taxation to keep public expenditure growing. This perspective favours fiscal federalism because the diffusion of tax powers across levels of government is considered helpful in limiting the concentration of taxing power at any one level of government and thereby keep growth of the public sector in check.

According to the market preserving federalism perspective, federalism enhances economic efficiency by creating market preserving conditions. By devolving regulatory

authority from central government to local governments, the interventionist role of the central government is constrained. At the same time, subnational governments are also constrained by the competition with one another. But, competition among subnational jurisdictions enhances efficiency only if all governments operate under hard budget constraints and have to bear full responsibility for their fiscal choices. Accordingly, this perspective does not favour intergovernmental fiscal transfers, which are considered to weaken fiscal discipline and accountability of governments.

The basic premise of the incomplete contracts perspective is that in the fundamental sense, a federal constitution is also like an incomplete contract, and this feature creates strong incentives for each contracting party to gain influence over other parties. Intergovernmental financial transfers are an important instrument for, and source of, gaining such influence.

In the traditional literature on public finance, intergovernmental fiscal transfers were viewed, somewhat naively, as simply transferring budgetary resources from one government level to another, without carrying with them any hidden risks of centralisation or fiscal domination. Viewed through the prism of incomplete contracts, however, fiscal transfers turn out to be powerful weapons for gaining influence, because governments are now recognised to actively seek to acquire for themselves a position of power over their contractual partners so that they can influence the future of government policies and intergovernmental relations. From the standpoint of the evolution of federalism over time, therefore, a fiscal transfer should never be considered a neutral transaction; it is rather a potential instrument of intergovernmental control. Given the highly centralised pattern of taxation revenues and the considerable extent of decentralisation of public expenditures in Australia, fiscal transfers from the Commonwealth to the states have indeed contributed to the growing power of the Commonwealth.

In the context of incomplete contracts, even the traditional distinction between conditional and unconditional fiscal transfers becomes far less important, as it is the total dependence of one level of government on another that determines the dynamics of intergovernmental relations and power plays.

Several lessons are drawn from this discussion:

1. Federalism is a desirable form of public sector for satisfying diverse preferences for government services within a national polity and for efficiency enhancing innovation and experimentation in governance.
2. Constitutional assignment of responsibilities is unlikely to remain static forever and must evolve over time. Some of this evolution will occur through constitutional amendment, but some will without constitutional amendments (for example, via interpretations of the Constitution by the High Court of Australia). It is important, therefore, to ensure that the extra-constitutional evolution does not undermine the federal character of the constitution.
3. Decentralisation of tax powers forms the core of federalism and influences the dynamics of its evolution. It has certainly played a key role in the evolution of Australia's federalism in the post-war period.
4. Independent research into theoretical and empirical aspects of fiscal federalism must be promoted. Both external and internal dynamics influence the longer term stability of federalism. New situations require innovative responses. The national government is as much a part of the political competition in a federation as the subnational governments. Independent research can be extremely valuable in developing and analysing the implications, costs and benefits of available alternatives.

5. Organisational structures for effective intergovernmental coordination must be developed to enable subnational governments to take part in horizontal coordination without the involvement of the national government. In this respect the historical record of the Australian states is disappointing. The states' apathy and inability to productively work with one another has created time and again an institutional vacuum to be filled by Commonwealth intervention – which has almost always resulted in greater centralisation. States are not entirely blameless in this regard and they have wittingly or unwittingly allowed this vacuum to emerge, and allowed the Commonwealth to expand its policy space at their expense.

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## The principle of subsidiarity

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Central to any discussion of decentralisation and federalism is the principle of subsidiarity. This principle is anchored in the concept of sovereignty of the individual; all other levels of social organisation are given a subsidiary role, taking up only those tasks and responsibilities that are beyond the capacity of the individual.

In the context of assignment of governmental functions, this principle suggests that powers and responsibilities should be assigned to the lowest level of government practicable. This principle supports maximum local inputs into governmental decisions to ensure maximum responsiveness to local needs and preferences.

The division of powers and responsibilities in the Australian Constitution can be viewed broadly consistent with the subsidiarity principle, as only a limited number of functions (that cannot be effectively discharged by state governments) are assigned to the Commonwealth, and all other functions remain with the states. The practice of intergovernmental fiscal relations has evolved quite differently, however, and the Commonwealth Government is heavily involved in many state functions, including education, health, transport, housing and the environment.

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## Five economic perspectives on federalism

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Economic theories of federalism originated in the mid-1950s as an offshoot of the modern theory of public goods.<sup>1</sup> Since then, new theories have emerged, reflecting deeper understanding of the democratic governance and the public sector. Together, these perspectives on federalism have helped identify, analyse and popularise the virtues and the limitations of fiscal decentralisation.

The following five economic perspectives do not in themselves provide a blueprint for an ideal assignment of responsibilities in a federation. However, they do provide valuable principles, concepts and criteria, which can guide the practitioners of federalism by providing better understanding of the nature of federations and of the patterns of intergovernmental relations.

## The public goods perspective

The main focus of the public goods approach to federalism is the diversity of preferences for public goods and assigning governmental responsibilities in a federal system to satisfy diverse preferences with maximum efficiency. Early in the development of the modern theory of public goods, it became clear that market pricing of public goods would be impossible due to the free rider problem. Charles Tiebout hypothesised, however, that the free rider problem might not be insurmountable for public goods that subnational governments provide. This is because preferences for these goods must be revealed by consumers moving between local government jurisdictions in their desire to reside in the particular jurisdiction in which the provision of public goods best matches their preferences.<sup>2</sup> This mobility between local jurisdictions has been likened to ‘voting with feet’ and is considered a signalling mechanism for revealing consumer preferences for subnational public goods. On this reasoning, it was claimed that fiscal federalism was the most efficient form of public sector.<sup>3</sup>

The insight that different public goods have different geographic domains has been the key in answering the next question: Which public goods should be provided at the national level and which at subnational levels?

Public goods are distinguished from private goods on the criteria of non-rivalness and non-exclusion. The public goods theory of fiscal federalism is based on the premise that any public good retains its ‘publicness’ within a particular geographic domain, beyond which it no longer remains non-rival in consumption. Different public goods have different geographic domains. Thus, a public good like national defence remains non-rival and equally available to all citizens of a nation. In contrast, a public good like street lighting retains its publicness only when it is consumed within a relatively small geographic area.

The notion of geographically based public goods provided the basis for establishing a hierarchy of public goods.<sup>4</sup> Public goods that retain their publicness over only a local government area, for example, street lighting and traffic control, may be labelled ‘local’ public goods. Those that retain their publicness over wider areas, for example, education and healthcare, may be appropriately labelled ‘state or provincial’ public goods. Public goods that retain their publicness for the whole nation, for example, immigration policies, national currency management and national defence, may be called ‘national’ public goods. By the same logic, public goods such as world peace or global climate can be added to this hierarchy as ‘global’ public goods.

Once a hierarchy of spatially arranged public goods has been established, it was suggested that a federation would represent the optimal organisation of the public sector if the hierarchy of public goods perfectly corresponded with the hierarchy of the governance structures – the so-called principle of perfect correspondence or fiscal equivalence.<sup>5</sup>

By matching the governance structures with the benefit spans of different public goods, the principle of fiscal equivalence ensures that the principle of subsidiarity is also upheld, because only those public goods are assigned to the national government that cannot be efficiently provided by the subnational governments. Such perfect correspondence between the two hierarchies is considered to ensure that all objective benefits of local public goods are exhausted within the boundaries of the local governments, which are empowered to make all decisions regarding the production and supply of these local public goods. Similarly, the benefits of ‘state’ public goods should be exhausted within the boundaries of state governments, and so on. On this reasoning, it has been claimed that “the best distribution of authority is the one which exists in a federation”.<sup>6</sup>

### The organisational costs perspective

The proponents of the organisational costs perspective on federalism reject the claim that a theory of federalism can be based simply on the notion of geographic boundaries of public goods. The starting point of the organisational costs theory is that the structure of the public sector must be determined in full recognition of all organisational costs of a public sector, including the costs the voters incur in signalling their preferences for public goods (through political participation, voting and mobility), and the costs all levels of government incur in administration and coordination.<sup>7</sup> This approach aims to assign responsibilities in a way that minimises total organisational costs. Functions should be reassigned between levels of government from time to time, as necessary, to ensure that organisational costs are kept at the minimum possible level all the time. Indeed, it is suggested as part of this theory that constituent assemblies should be established to monitor the organisational costs and to undertake periodic reassignment when warranted by the changing nature of people's preferences or technologies for producing or providing public goods.

Formulated in the late 1970s, the organisational costs theory reflected the widely shared concerns about the escalating costs of the public sector in many developed countries. Coupled with the stagflation of those years (when high rates of inflation co-existed with slow economic growth), this theory acknowledged that intergovernmental relations in every federation must be subjected to continuing scrutiny and review to minimise public sector costs. This is not all that this theory was proposing. This theory was also calling for monitoring, and adjusting to, the evolution of federalism over time – something that had been ignored in the public goods perspective. The organisational costs theory acknowledged that assignment patterns of federalism need to be monitored and evaluated because they are dynamic and likely to change in response to economic and technological development.

### The public choice perspective

Inspired mainly by the writings of James Buchanan and Gordon Tulloch, the public choice perspective is based on the premise that in the absence of appropriate institutional constraints, the natural tendency of a government is to use its monopoly over taxation to keep public expenditure growing. The public choice approach favours fiscal federalism over unitary government because the multiplicity of governments is considered helpful to limit the concentration of taxing power of each level of government and thereby contain the growth of the public sector.

In a debate on the subject, the founder of the public choice perspective, James Buchanan, emphasised that even if the division of functions between the national government and subnational governments is inefficient, there would still be an argument in favour of delegating some power to subnational governments as a means of controlling the central government authority.<sup>8</sup> Thus, fiscal federalism provides not only greater scope for the satisfaction of heterogeneous preferences for public goods – something that would not be possible in a centralised public sector – it also dilutes the concentration of authority over taxation. Federalism also contains the threat of potential exit (via inter-jurisdictional mobility), which in turn constrains the governments' power to exploit.

Unlike the previous two perspectives, the public choice perspective on federalism provides little guidance, however, regarding which level of government should have responsibility for which functions.

### The market preserving federalism perspective

In the 1990s, Weingast,<sup>9</sup> and Qian and Weingast,<sup>10</sup> and others contributed to the development of a new perspective on federalism. According to this perspective – the market preserving federalism perspective – federalism enhances economic efficiency by creating market preserving conditions. The main argument is that by devolving regulatory authority from central government to local governments, the interventionist role of the central government is constrained. At the same time, regulatory power is assigned to subnational governments that are also constrained by the need to compete with other subnational jurisdictions. If they do not compete, they are faced with the threat of voters moving to other (better) jurisdictions. Thus, competition among subnational jurisdictions acts as a powerful force for enhancing experimentation and innovation in the provision of local public goods.

What if the subnational governments compete with one another by lowering taxes and increasing public spending? This type of competition – the so-called race to the bottom – is not unknown to have occurred in most federations from time to time. To prevent such subversive competition, a key condition of the market preserving federalism is that subnational governments must operate under hard budget constraints. For this to happen, the market preserving federalism perspective does not favour intergovernmental fiscal transfers because such transfers undermine fiscal accountability by weakening the link between spending decisions and revenue raising decisions.

While the emphasis on maintaining the fiscal discipline through hard budget constraints is understandable, a serious weakness of the market preserving federalism perspective is that it ignores the objective of horizontal equity across subnational jurisdictions. Taxable capacity is rarely distributed equally among subnational jurisdictions in any federation, with the result that some jurisdictions can raise more revenue than others even if the same tax rates are applied. Unless appropriate mechanisms are developed and implemented for horizontal fiscal equalisation, levels of government services will be different across states or provinces even if tax rates are identical.

To reduce the effects of horizontal fiscal imbalances of this type, arrangements for horizontal fiscal equalisation are made in most countries, including Australia, Canada, Germany, India, Malaysia and Switzerland.<sup>11</sup> In Australia, the arrangements result in fiscal transfers from New South Wales, Victoria and Western Australia to the other states and territories based on the assessments made by the Commonwealth Grants Commission.

### The incomplete contracts perspective

All four aforementioned perspectives have one feature in common: they are all normative constructs derived from specific premises and assumptions. They are all models of how a federation 'ought to be'. In contrast, the incomplete contracts perspective offers a positive model derived from empirical analysis of how federal systems actually work and what motivates governments to engage in competition. The assumptions and the hypotheses in this model are derived from empirical observation and are based in the tradition of the new institutional economics.

In departure from the earlier neoclassical tradition, which was primarily focused on the operation of markets, the new institutional economics is focused on how:

- Institutions (that is, rules of behaviour) affect the operations and the outcomes of exchange; and
- Institutional inducements are reflected in the development of markets.

Institutions are described in this literature as humanly devised constraints that shape human interaction, and include both formal constraints such as rules, laws and constitutions, and informal constraints such as norms of behaviour, customs, conventions and self-imposed codes of conduct.<sup>12</sup> While institutions embody rules of the game, organisations are the players of the game. For example, the Australian Constitution is an institution formally created with the deliberate intent of defining the constraints on the Commonwealth Government's legislative authority, whereas the Federal Parliament, state legislatures and the High Court of Australia are important organisations through which the Constitution functions. Both the institutions and organisations may change over time in response to external factors or changes in enforcement.

The concept of incomplete contracts is based fundamentally on the need to transact business among separate entities, none of which can foresee and predict the future completely.<sup>13</sup> If it were possible to observe all actions and events without error or uncertainty, and to foresee with assurance all future events, or to identify, plan for and contract for all future circumstances without incurring costs, parties engaged in economic activity could enter into comprehensive or complete contracts. These contracts would not have to be revised at any time in the future because they identified and provided a contractual response to every situation that might arise. Of course, in reality it is not possible to observe the present without error or to foresee the future without uncertainty. Nor is it generally possible to identify and monitor all actions of all parties to a contract. Thus, all contracts are necessarily incomplete, in at least one of the two senses. Either some future circumstances will arise that are not covered by the contract, and in which a new decision will have to be made, or present or future inputs by, or benefits to, parties will not be completely observable or measurable.

The economic significance of incomplete contracts derives from the responses and strategies of the agents in dealing with this reality of incomplete contracts. As Hart pointed out, a firm may now prefer ownership of assets to contract-based exchange. This is because ownership also provides the firm with residual rights of control over the assets unlike contract-based exchange. Ownership thus becomes "a source of power when contracts are incomplete".<sup>14</sup>

It has been further suggested that in the fundamental sense, a federal constitution is a contract between the state and the people of a country, according to which specific powers to make laws are assigned between national and subnational governments.<sup>15</sup>

Like other contracts, a federal constitution is also an incomplete contract, as legislative domain of neither national nor subnational governments is fixed forever and there is always room for dispute over the meaning and intent of some clauses, and for future amendments. Numerous intergovernmental agreements and fiscal transfers operate within this environment of incomplete contracts. In a federation, this incompleteness of constitutional contract adds a new dimension to the strategic objectives of governments. This is because incomplete contracts create opportunities and incentives for intergovernmental struggle for domination and power play over the specific aspects of governance.

The motivation to ensure that public goods match the preferences of voters and that the tax costs are kept to the minimum would force governments to remain fully informed about the voters' preferences and enable them to effectively respond to voters' demands. Accordingly, each government seeks to ensure that:

- a) It can do more for the voters than the competing governments; and
- b) It has maximum support and minimum opposition from the rival governments in implementing its policies and programs.

Intergovernmental financial transfers are an important feature of federal finance. Given the highly centralised pattern of taxation revenues and the considerable extent of decentralisation of public expenditures, fiscal transfers from the Commonwealth to the states are also key features of Australian federalism.

In the traditional literature on public finance, intergovernmental fiscal transfers are viewed, somewhat naively, as shifting budgetary resources from one level to another without carrying with them any subtle risks of centralisation or fiscal domination. Viewed through the prism of incomplete contracts, however, fiscal transfers become powerful weapons for gaining influence. This is because governments now are recognised to actively seek to acquire for themselves a position of power over their contractual partners so that they can influence the future shape of intergovernmental relations. From the standpoint of the evolution of federalism over time, therefore, a fiscal transfer should never be considered a neutral transaction – it is rather a powerful instrument of intergovernmental control.

The traditional distinction between conditional and unconditional fiscal transfers also becomes far less important in the context of incomplete contracts, as it is the total dependence of one level of government on another that determines the dynamics of intergovernmental relations and power plays.

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## Dynamics of constitutional federalism

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Constitutional assignment of powers in a federation will change over time. Indeed, every federal constitution makes provision for amendment of its clauses when necessary. Australia is not an exception. What is exceptional in Australia's case is the fact that much of the evolution in fiscal relations between the Commonwealth and the states has occurred through constitutional interpretations by the High Court of Australia, not by constitutional amendments.

During the first 70 years of the 20th Century, the roles and responsibilities of governments increased under the impact of the two world wars, the Great Depression, and the post-war growth in social expenditures. The initial impact of these forces was towards greater centralisation in federal countries, as national governments were drawn into broader policymaking and financing responsibilities that had been constitutionally assigned to subnational governments, such as education, health, transport and housing.

Since the mid-1930s, new insights gained from the Keynesian economics of macroeconomic management also boosted the economic role of national governments. Similarly, broader community expectations about redistribution of income and wealth added to the economic responsibilities of national governments, both for progressive taxation and public expenditures. In recent decades, the processes of globalisation and liberalisation of rules of trade and investment have further boosted this process, highlighting the benefits of uniform regulatory regimes for extending the scope of single markets. These developments have favoured a shift towards greater uniformity and less diversity in government economic and social policies. In Australia, where the federal Constitution had assigned only limited powers to the Commonwealth, these developments strengthened the need for a stronger national government, particularly for those who viewed interstate rivalries (for example, different width railway gauges and fragmented internal markets) as sources of weakness, and those who recognised the strategic vulnerabilities of Australia's European population geographically surrounded by Asian nations and too weak to defend itself against possible external threats.

From around the 1920s, constitutional interpretations by the High Court of Australia started showing clear signs of being aimed at enabling the ‘Commonwealth’ Government to become the truly ‘national’ government for which states should not constrain powers over national policies.<sup>16</sup>

Eager to implement progressive social reforms in the post-war period, Commonwealth administrations under both major parties, the Australian Labor Party (ALP) and the Liberal-Country Party Coalition, welcomed the trend towards greater centralisation. The Whitlam Administration (1973–1975) witnessed an unprecedented growth in the role of the Commonwealth into state subjects, many of which had been admittedly starved of funding in the previous decades, for instance, education, health and urban infrastructure. The Fraser Administration (1976–1983) promised to reduce intergovernmental overlap and duplication by reforming specific purpose payments (SPPs) to the states, although little was changed in reality. Prime Minister Fraser did, however, establish the Advisory Council of Intergovernmental Relations (ACIR). Its mission was to undertake research for improving intergovernmental fiscal relations. Together with the Centre for Research on Federal Financial Relations (CRFFR), which had been established in 1972 by the McMahon Government at the Australian National University, the ACIR made important contributions to research on fiscal federalism.<sup>17</sup>

The ACIR was closed down in the mid-1980s by then Treasurer, Paul Keating. A few years later, when he became Prime Minister, Keating also withdrew Commonwealth funding of the CRFFR, a decision that predictably led to the closure of the CRFFR. Since then, there has been no dedicated research unit focusing on fiscal federalism in Australia. By default, the Commonwealth public service and the business advocacy groups appear to have become the main source of expertise, review, evaluation and commentary in this field. Most often they tend to favour uniformity over diversity and centralisation over decentralisation.

Keating also helped to derail the process of reform of federalism under the auspices of the Special Premiers’ Conference 1990–91, which had established two Commonwealth-state working groups on the vertical fiscal imbalance and the rationalisation of Commonwealth SPPs to the states. Having resigned as Federal Treasurer after losing a Party Room challenge to Prime Minister Hawke, in October 1991, Keating delivered in his National Press Club address the warning that “[t]he national perspective dominates Australian political life because the national government dominates revenue raising and only because the national government dominates revenue raising”.<sup>18</sup> This generated ALP Caucus pressure on Prime Minister Hawke not to proceed with the proposed fiscal reforms, and the Commonwealth Government’s participation in the scheduled Special Premiers’ Conference in Adelaide was cancelled. In the end, while the state and territory governments met in Adelaide, little tangible progress was possible without the Commonwealth cooperation on either vertical fiscal imbalance or the rationalisation of SPPs.<sup>19</sup>

Meanwhile, Australia’s taxation system had become highly centralised as a consequence of the High Court’s decisions on income tax and on section 90 of the Constitution, which prohibits the states from levying excise duties. However, as there is no clear definition of excise duties in the Constitution, the task of determining whether a particular state tax constitutes an excise duty rests with the High Court.<sup>20</sup> In August 1997, the High Court ruled that business franchise fees levied by all states and territories on petrol, tobacco and liquor were in breach of section 90 of the Constitution.<sup>21</sup> Overnight, the states and territories lost a major source of revenue. In a swift and effective response of intergovernmental cooperation, the Commonwealth and state governments reached an agreement under which the Commonwealth would collect these revenues under its legislation (which is not restricted by section 90) and return the funds to the states and territories.

When the Goods and Services Tax (GST) was enacted in 2001, the Commonwealth agreed to return the entire revenue (less administrative cost) to the states and territories. In recent years, due to the lopsided growth of the economies of the states during the resources boom, there has been debate about the manner in which the Commonwealth Grants Commission assesses the GST revenue shares. There has also been a debate whether reform of the GST should be a part of overall tax reforms. The fact that GST is levied by the Commonwealth makes it a part of the Commonwealth taxation. However, because the Commonwealth has agreed that the rates of GST will not be changed without the consent of the states and territories, which receive all GST revenue, it cannot alone decide the fate of GST.

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## Federalism with shared responsibilities

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The expansion in the role of the Commonwealth into state functions has created in Australia a federation with shared responsibilities in many functions, particularly in education, health, transport and the environment. To function properly, policy formation and administration in these functions require continuing intergovernmental cooperation and coordination.

Intergovernmental cooperation has been attempted through the use of fiscal instruments, for example, SPPs, combined with the creation of intergovernmental forums such as ministerial councils and the Council of Australian Governments (COAG). The high degree of vertical fiscal imbalance in Australia (which means continuing and heavy dependence of state public finances on Commonwealth fiscal transfers) also casts a long shadow over the functioning of these intergovernmental mechanisms and forums. In spite of certain isolated examples of cooperation between the two levels, policy environment in these functions remains heavily polluted by duplication, overlap, loss of accountability, blame shifting and gamesmanship.

Some observers have described Australian federalism as “dysfunctional”,<sup>22</sup> or “rickety”.<sup>23</sup> Others have called for the abolition of the states.<sup>24</sup> Justice Robert French, President of the Federal Court at the time and appointed Chief Justice of the High Court of Australia soon after delivering this paper, concluded his careful analysis of Australia’s experience with cooperative federalism in the following words:

“Cooperative federalism today is in part extra-constitutional. Driven by political imperatives it yields results on a consensual basis which go well beyond those achievable by the exercise of Commonwealth legislative power and the separate exercise by the states of those powers. In that sense the cooperative federalism movement may be seen to overshadow expansive interpretations of Commonwealth power under the Constitution. And in my opinion, although cooperative and thus respecting the formal constitutional position of the states, it contributes towards centralisation. For every topic which is treated as national becomes potentially a matter which, somewhere along the line, it can be argued is best dealt with by a national government.

“That may in turn be used in future argument favouring Commonwealth control and accountability in respect of such matters. If the states are not perceived by electors as adequately discharging their constitutional responsibilities then such perceptions will feed into the legitimisation of national control. A shrinking federation will continue to shrink. The logical outcome is the singular state of a unitary federation. That is the federation you have when you do not have a federation.”<sup>25</sup>

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## Conclusion

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Several lessons emerge from the foregoing discussion. The first lesson is that all economic perspectives on federalism (or decentralisation) reach the important conclusion that fiscal decentralisation and federalism should be the preferred form of public sector for various reasons, including:

- The ability to satisfy diverse preferences for government services;
- The protection from monopoly power over taxation and public expenditures;
- The efficiency enhancing gains generated by the competition among subnational governments; and
- The greater scope for innovation and experimentation in government policies.

These benefits of federalism can be strengthened if, as suggested by the market preserving federalism model, subnational governments are made to operate under hard budget constraints.

The second lesson is that constitutional assignment of responsibilities is bound to evolve over time. Some of this evolution may occur due to formal constitutional amendments, and some will occur without such amendments, through interpretations of the constitution, as has happened in Australia. It is important to ensure, therefore, that legal interpretations of the Constitution do not undermine the federal character of the Constitution.

The third lesson, highlighted by the incomplete contracts perspective, is that decentralisation of tax powers forms the core of federalism and shapes the dynamics of its evolution. The provinces in Canada, for example, surrendered income tax powers to the federal government during World War II, but got these powers back in the 1960s and are now able to finance provincial services with minimum reliance on federal fiscal transfers. In Australia, where the states also surrendered income tax powers to the Commonwealth during World War II, the states never got this power back and have become permanently and heavily dependent on fiscal transfers. After the episode of the Special Premiers' Conference in 1991, the issue of state tax powers seems to have died out, particularly now that the states have access to GST revenue. But, GST is not a state tax and the states cannot change its tax base or tax rate. GST revenue is also allocated to individual states and territories each year on the basis of fiscal equalisation assessments made by the Commonwealth Grants Commission. If the states had access to a broadly based state tax, many of the small and inefficient state taxes could be abolished – improving the efficiency of the overall tax system of the country.

The fourth lesson is that independent research into theoretical and empirical aspects of fiscal federalism must be promoted. As we have noted, the longer term stability of federalism is influenced by both external and internal dynamics. New situations require innovative responses. The national government is as much a part of the political competition in a federation as the subnational governments. Independent research can be extremely valuable in developing and analysing such situations. Australia is currently not well served in this respect, whereas Canada and the United States have many sources of independent research on federalism, as have other European federations.

And finally, organisational structures must be developed so that subnational governments can take part in horizontal coordination without necessarily the involvement of the Commonwealth Government. The historical record of the Australian states in this respect is rather poor, and has repeatedly created an institutional vacuum to be filled by the Commonwealth – with the result of greater centralisation. It has to be said that

states are not entirely powerless in this regard and that they have wittingly or unwittingly allowed this vacuum to emerge and allowed the Commonwealth to expand its policy space. As Tony Abbott remarked in his Norman Cowper Oration, it is almost impossible to recall a state government objecting to an extension of federal powers to secure some state goal.<sup>26</sup>

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## 1.3

# Federalism and diversity in Australia

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## Why is Australia a federation?

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The first and most important reason that Australia is a federation is political.<sup>2</sup> The colony of New South Wales (NSW) once occupied about two-thirds of the continent. However, those who settled in the towns that we now know as Melbourne and Brisbane soon agitated for the right to local self-government. They secured this midway through the 19th Century through the establishment of Victoria and Queensland as separate, independent and self-governing colonies. Having enjoyed the benefits of local self-government for some decades, when in the latter half of the 19th Century the Australian colonies began to consider the possibility of forming an Australia-wide level of government, they were not about to give up their rights to self-government in the process. Federation was a means by which both orders of government could co-exist, enabling the people of each state to govern themselves with a substantial measure of independence, while enabling the people of Australia as a whole to do so as well.

The basic rationale for Australian federalism therefore wasn't to accommodate cultural diversity between states.<sup>3</sup> Australia is a diverse country, but its diversity, by international standards, is not concentrated in particular states, regions or cities. Australia is not like Canada, where approximately 80 per cent of the French-speaking population is concentrated in Québec.<sup>4</sup> Nor is Australia like Switzerland, where the speakers of the four national languages and adherents of the two major religious groupings are concentrated within particular cantons.<sup>5</sup> In both these countries, like many others, the federal political structure reflects, reinforces and manages the existence of cultural heterogeneity that has a territorial or spatial expression. By contrast, in Australia, although migration patterns have caused the population to become increasingly diverse, English remains the dominant language, and cultural, religious and ethnic minorities are not concentrated into particular local areas, regions or states to the degree they are in many other federal countries. In *relative* terms, Australia is territorially homogeneous.<sup>6</sup>

Below the surface of this homogeneity, however, there is a significant 'second order' diversity that does distinguish Australia's states, regions and cities in important ways. Moreover, as a result of international immigration and domestic migration patterns, it seems that Australia's states and regions are becoming more diverse, not less. While not marked by ethno-cultural concentrations of population of the intensity found in some other federations, Australia's states, regions and localities nonetheless display important diversities across a number of 'cultural' markers, such as ethnicity, religion and language, as well as several important 'economic' measures, such as types of industry and commerce, and levels of income and disposable wealth. Moreover, these economic variations are significantly related to Australia's fundamental demographics. While most of the national population is concentrated in the major cities, there are significant state and regional variations in, for example, the relative densities of population centres, age profile and in the relative remoteness of human settlements. These sorts of differences are complicated further by significant differences in natural resources and industrial development among states, regions and cities, all of which feed back into variations in socioeconomic patterns and in certain respects relate to variations in ethno-cultural identity. Indeed, this last point is especially noticeable in the case of indigenous peoples living in remote areas, and in relation to other ethno-cultural minorities.

Australia's states and local governments in certain important respects display subtly different policy emphases, expressed both in budgeting priorities and broader political concerns, some of which appear to be related to the socioeconomic and ethno-cultural characteristics of the state or locality in question. Policy diversity, though diluted and at times overruled by federal government measures of far-reaching extent, is a

fact of Australian state and local politics. Its very existence suggests a rationale for the maintenance and development of a system of multilevel governance. This is not only in the sense that policy diversity is itself a good thing for innovation and competition, but also because policy diversity in Australia is related to, and shaped by, ethno-cultural, socioeconomic and demographic differences that have a significant territorial or spatial expression, differences that may well increase in intensity in the foreseeable future.

Australia's diversity presents a highly complex, though subtle picture of cross-cutting cleavages that have a significant spatial or territorial expression. Contrary to the received wisdom, multilevel governance in Australia *does* have a diversity rationale. Policymakers in particular state and local jurisdictions have long been aware of, and responsive to, the unique conditions of their respective regions and localities. It is just that this fact has too often been overlooked when the federal system as a whole has been considered.

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## Australia in 1901

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On the eve of federation in 1901, the populations of the Australian colonies were overwhelmingly of Anglo-Celtic origin and shared the same basic political institutions, language and culture.<sup>8</sup> The indigenous population, estimated to have been at least 315,000 in 1788, declined rapidly to be below 100,000 by 1901. By that date, the settler population had grown to almost 3.8 million.<sup>9</sup> The most significant non-British migrant groups – German, Chinese, Scandinavian and Polynesian<sup>10</sup> – though representing not insubstantial populations, were far exceeded by the number of inhabitants already born in Australia, or recently emigrated from England, Ireland and Scotland.

While in 1901 the overall picture was, therefore, of a relatively homogenous, predominantly British population across each of the former colonies, closer analysis reveals a more variegated picture. Among the Anglo-Celtic settler populations themselves, there were definite differences between those of English, Irish and Scottish ancestry, as well as between those of Anglican, Catholic, Presbyterian and Methodist denominational adherence.<sup>11</sup> Further, non-British groups tended to settle in very specific patterns. Between the 1840s and the 1890s, more than 100,000 Chinese entered the Australian colonies, concentrated initially in the gold fields of Victoria and NSW, and later those of Queensland and Western Australia (WA).<sup>12</sup> German immigrants were concentrated especially in South Australia (SA) and Queensland.<sup>13</sup> Over 62,000 South Pacific Islanders also entered Queensland between 1863 and 1904, most of them indentured to work in sugar plantations along the north coast.<sup>14</sup>

The settlement patterns among these and other groups meant that in 1901, while NSW, Victoria and Tasmania had a similar distribution of people from various birth-places as their shares of the national population would suggest, the 'frontier' states of Queensland, SA and WA had attracted larger than their pro-rata shares of particular migrant groups. Indeed, while British settlers dominated the capital cities and other major population centres of each colony, the most significant non-British groups chose, or were obliged, to live in more rural, regional and remote areas of the continent. These local and regional concentrations of minority groups shaped the demographics, and the politics, of each of the colonies in different ways. Especially in relation to indigenous peoples, the nation was already displaying a significant 'second order' degree of spatially defined ethno-cultural diversity, which continues to this day. The presence of non-British peoples, especially in the 'frontier' colonies, influenced conceptions of 'Australian identity' and contributed to the later development of the White Australia policy at a national level.<sup>15</sup>

The colonial economies were also in certain respects significantly different. Sydney's economy was more oriented to commerce and trade, and NSW governments tended to favour free trade policies. The economies of Melbourne and Adelaide, meanwhile, were becoming proportionately more industrial and their governments tended to favour relatively high tariffs as a means of encouraging and protecting local industries.<sup>16</sup> Queensland's economic situation was different again; its sugar industry, though still in its infancy, was dependent upon Kanaka labour in the north. Moreover, in the 1890s, WA was grappling with the influx of people into the Coolgardie and Kalgoorlie gold fields and had only acquired powers of local self-government in 1890 – whereas the other colonies had enjoyed responsible government since the mid-1850s.

As such, while Australian federalism was not consciously devised as a response to territorially defined ethno-cultural diversity, the different social, economic and political conditions of each colony reinforced the perception that each colony should continue to enjoy significant powers of local self-government. Federation was a response to the sheer size and diversity of the continent. It was also based upon an underlying belief in the virtues of self-government and self-determination, at a state and national level. The federal system was principally seen as a political arrangement that would preserve the capacities of the states to attend to their own affairs while creating a federal government with sufficient powers to address the issues they had in common. The goals of federation were therefore primarily political in this sense, and not specifically concerned to preserve a plurality of ethno-cultural identities as such.<sup>17</sup> However, differences in the social, economic and political histories of the colonies gave rise to variations in local political culture, all of which were reflected in the debate over federation during the 1890s.<sup>18</sup> Unity in diversity was the goal, and a federal constitution that would “enlarge the powers of self-government of the people of Australia”,<sup>19</sup> at both a state and a federal level, was intended to achieve exactly this.

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## Demographic patterns since federation

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Since federation, the picture has changed, in some respects very significantly. In 1901, the relatively large populations of NSW and Victoria far exceeded those of the other colonies. Today, those states still have larger populations than the others. However, Queensland and WA have made up much of the ground, a long-term trend reinforced in recent decades by two key drivers of population growth, namely resources-led jobs growth, and lifestyle and environmental factors.

Relative population growth in Queensland and WA has been at the expense of most other states and territories. Queensland's share of the national population increased from 13.2 per cent in 1901 to 20.2 per cent by 2009. Over the same period, WA doubled its share of the population, while NSW and Victoria's shares declined significantly.

Although the net population of all states and territories has grown, the contribution made by the three different components of growth – natural increase, net overseas immigration and net interstate migration – differs substantially. This appears to have significantly affected the demographic profiles of the states. In 2009–10, for example, growth in Tasmania, the Australian Capital Territory (ACT) and the Northern Territory (NT) was due mostly to natural increase; NSW, Victoria and SA gained population largely through net overseas immigration; whereas Queensland and WA experienced relatively high positive net interstate migration, with correspondingly significant negative net interstate migration for NSW and SA.<sup>20</sup>

These broad differences in sources and magnitude of population growth, as well as more finely-grained differences in the ethno-cultural and socioeconomic drivers of population change, have led to significantly different sets of issues confronted by state governments in terms of such matters as multicultural policies, economic development, infrastructure, and so on. The policy pressures posed by significant numbers of newly arrived migrants from non-English speaking backgrounds in NSW and Victoria are very different from the issues faced by low-growth states such as Tasmania and SA, which are in turn very different from those encountered by high-growth states such as Queensland and WA, where the majority of newcomers are predominantly English speaking.

The age profiles of the states and territories are also significantly different. In 2009, Tasmania and SA recorded the oldest populations, whereas the NT had by far the youngest population. These patterns reflect longstanding migration trends where young people tend to move to access employment or other lifestyle opportunities, often in a capital city, leaving an older population behind. The economic implications of these statistics are significant. In addition to changing distributions of population, there has been a dramatic urbanisation of the population as a whole. This is clearly evident in the share of each state and territory's population that is resident in its capital city. In all cases, a sizeable shift to the capital city has occurred since 1901. Australia is now one of the most urbanised countries in the world.<sup>21</sup> However, there are also important differences. In 2006, Queensland and Tasmania still had less than half of their populations in the capital city, and the NT only slightly more than 50 per cent. These statistics have a significant impact on access to goods and services, especially for very remote local communities in WA and the NT, many of them predominantly indigenous.

These variations between the states and territories have significant implications for matters that necessarily engage the attention of policymakers at local, state, territory and Commonwealth levels in very different ways. These matters include access to services, economic opportunities, costs of living, prospects of community interaction and political participation.

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## Ethno-cultural diversity

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Australia has long experienced waves of overseas migration. Prior to World War II, most immigrants came from Western and Northern Europe. However, in the 1950s, people from Southern Europe, and in the 1960s, people from Eastern Europe, Asia and the Middle East, diversified Australia's ethnic mix.<sup>21</sup> These immigration flows have contributed to a highly complex and rich cultural diversity in most of Australia's capital cities and major regions. However, when the data is closely examined, there are significant variations across the states and territories.

Victoria was the focus for much of the post-war wave of Greek and Italian migrants. The result was that by 2006, 46.7 per cent of Australians who spoke Greek and 42.1 per cent of all Italian speakers lived in Victoria. In contrast, 67.7 per cent of Arabic speakers, 54.5 per cent of Hindi speakers and 53.0 per cent of Cantonese speakers lived in NSW. Queensland and WA presented a different picture, with many of the immigrants attracted to these states originating in English-speaking countries such as the United Kingdom, New Zealand and South Africa. Meanwhile, the NT continued to be the location of most speakers of Aboriginal languages. The pressures and changes caused by these international immigration patterns are especially prominent in WA,

NSW and Victoria. The national average of people born overseas is 24.6 per cent, but in Tasmania the figure is only 11.5 per cent, in WA it is 29.9 per cent, and in NSW and Victoria it is 26.5 and 26.3 per cent respectively.

Confirmation of the territorial and spatial dimensions of Australia's ethno-cultural diversity is seen in the fact that after English, of the five different languages most often used across Australia's states and territories in 2006, Italian featured as the second most common language in Victoria, SA and WA; Mandarin was the second most spoken language in Queensland and the ACT; Arabic followed by Cantonese were the most spoken non-English languages in NSW; German was second most spoken in Tasmania; and Djambarrpuyngu was the second most common language of the NT.

Religious identification provides a further indication of ethno-cultural diversity among Australia's states and territories. In 2006, 24.2 per cent of South Australians indicated they had no religion while the comparable share in NSW was only 14.3 per cent.<sup>23</sup> NSW also had the highest proportion of any state reporting their religion as Christianity (67.7 per cent) compared with 54.6 per cent in the NT and 59.3 per cent in WA.<sup>24</sup> Reflecting the concentration of immigrants from various non-European origins, NSW and Victoria also had the largest concentrations of non-Christian religions, especially Islam, Hinduism and Judaism. As a consequence, issues of multicultural accommodation are evidently more complex in those states, especially compared with relatively homogenous Tasmania.

Australia's indigenous population is also distributed disproportionately among the states and territories. It is concentrated especially in the NT (27.8 per cent), followed very distantly by WA, Queensland and Tasmania (each with just under four per cent). These figures diverge very sharply from those in Victoria, where in 2006, indigenous people made up only 0.6 per cent of the population. Clearly, the acute problems faced by many indigenous communities in the NT and the four territorially largest states present highly complex policy challenges, especially where those problems exist in the context of, and are compounded by, extreme remoteness and isolation, or concentration in heavily populated urban localities.

Speaking generally, the populations of NSW and Victoria exhibit the highest degrees of ethno-cultural diversity, whether measured in terms of ethnicity, language or religion, with the special case of the NT exhibiting an especially high concentration of indigenous people, many of them living in very remote communities. WA and Queensland form a second group with increasing numbers of those born overseas (but often English speaking) among their populations, as well as sizeable numbers of indigenous Australians. The remaining jurisdictions, especially Tasmania, comprise a third category with comparatively much smaller shares of their populations being ethnically or culturally diverse.

Multicultural policies in each Australian jurisdiction need to be constantly refined to take into account the unique sets of political needs and expectations that these ever-shifting patterns of ethno-cultural diversity generate. A national government may do its best to respond to these forces in a manner suitable to local conditions, but its responsiveness to the particular circumstances of each state, territory, region and locality will tend to be diluted by the unfamiliarity of distance, and distracted by competing expectations and priorities.

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## Socioeconomic variation

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Ethno-cultural diversity is compounded by socioeconomic variation across the states and territories. The fundamental economic conditions of each state and territory, reflected in gross state product (GSP) figures, when presented on a per capita basis, reveal considerable differences. Here, the per capita 'wealth' of the resource-rich WA and the NT is evident, as well as the significant concentration of economic flows within the ACT, driven by the location of the national capital. In contrast, Tasmania and SA have the lowest GSP per capita, reflecting not only the economic structure of their state economies but also the relatively older age of their populations. There is a difference of nearly \$35,000 from the highest GSP per capita in WA (\$81,159) to the lowest in Tasmania (\$46,185).

These differences between the states and territories are further highlighted by a consideration of the gross value added by particular industries in each jurisdiction, which varies considerably. The different economic histories and fortunes of the Australian states and territories have also resulted in significant variations in terms of production and purchasing power. Residents of the ACT (\$55,300) had easily the largest gross household disposable income per person in 2008–09, followed by WA (\$39,400) and the NT (\$38,700). By contrast, Queensland (\$33,200) and Tasmania (\$33,500) had the lowest per capita disposable income.<sup>25</sup>

The different economic conditions of each state and territory are generally taken to provide persuasive reasons for a significant degree of fiscal redistribution to be coordinated at a federal level. While up to a point this may indeed be the case, socioeconomic variation between the states and territories also provides good reason to allow sufficient room for policy flexibility and responsiveness by allowing each jurisdiction to exercise a significant degree of autonomy. This is particularly underscored when the ethno-cultural diversity between the states is taken into account. The significantly different concentrations of migrant populations in the various states create unique (and constantly shifting) sets of policy pressures. Policy settings need to be responsive to the ever-changing ensemble of socioeconomic and ethno-cultural conditions encountered in each jurisdiction. Australia's shifting ethno-cultural and socioeconomic diversity not only has significant territorial dimensions, but it makes policy diversity across Australia's jurisdictions an important and persistent imperative.

Despite the extent of Australia's ethno-cultural and socioeconomic diversity, powerful forces have long been pressing Australian politics in the direction of greater centralisation, uniformity and policy convergence. The decline in the policy autonomy of the states is especially caused by the fiscal dominance of a Commonwealth Government that collects over 80 per cent of all taxes in Australia and distributes to the states 50 per cent of their revenue, over 40 per cent of this provided in the form of conditional grants.<sup>26</sup> It is only within these budgetary constraints that the states and territories are free to formulate spending and policy priorities suited to the particular conditions, needs and aspirations of their respective populations, often driven by their particular socioeconomic and ethno-cultural characteristics.

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## Conclusion

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Territorial and spatial diversity is a matter of degree. Diversity can exist in various respects, whether ethno-cultural, socioeconomic or policy-political. Culture is itself a complex thing, consisting of various elements, such as language, religion, custom, ethnicity, relationship to land, and so on. Diversity is often marked by culture, but it can also be marked by other factors, such as socioeconomic conditions and the policy settings set by governments. Some federations are relatively homogenous in these various respects; others are more heterogeneous. Australia, like Brazil, Germany and the United States, has a single dominant language and, compared with many other federations, does not have any strongly pronounced ethno-cultural cleavages that are defined territorially.

However, to say simply that Australia is a 'culturally homogeneous federation' fails to capture the complexity of Australia's diversity in its important spatial and territorial dimensions. Australia's states, territories, regions and localities are more diverse than is usually appreciated. This diversity, expressed in demographic characteristics such as age profile, urbanisation and remoteness; ethno-cultural factors such as ethnicity, language and religion; and socioeconomic measures such as economic growth, pre-vailing industries and household income, provide good reason for a significant degree of policy autonomy to be exercised by the states and territories, and indeed also by local governments.

Contrary to the received wisdom, federalism makes good sense for Australia, given the sheer size of the continent, the variety of its geographical features and the diversity of its people. Even before federation, the colonies were more diverse than has generally been recognised. Certainly, the White Australia policy meant that during the first half of the 20th Century, Australia became in certain important respects less diverse, and this was accompanied by increasing government centralisation and uniformity of law and regulation that has only accelerated down to the present day. However, partly due to changes in immigration policy and partly due to economic and other factors, the states and territories are becoming more diverse, not less. In the context of this diversity, the states frequently seek out opportunities to respond directly to local expectations and regional conditions, albeit only within the interstices of policy autonomy still available to them. The room for policy diversity may have shrunk considerably, but the growing importance of ethno-cultural and socioeconomic diversity means that the reassertion of local autonomy, at a state and even at a municipal level, makes good sense for Australia.

## Endnotes

- 1 This paper draws substantially on: Aroney, N 2010, 'Australia' in Luis Moreno and César Colino (eds), *Diversity and Unity in Federal Countries*, McGill-Queen's University Press, p. 17; and Aroney, N; Prasser, S; and Taylor, A 2012, 'Federal Diversity in Australia – a Counter Narrative' in Gabrielle Appleby, Nicholas Aroney and Thomas John (eds), *The Future of Australian Federalism: International and Comparative Perspectives*, Cambridge University Press, p. 272.
- 2 For more detail, see: Galligan, B 1995, *A Federal Republic: Australia's Constitutional System of Government*, Cambridge University Press; and Aroney, N 2009, *The Constitution of a Federal Commonwealth: The Making and Meaning of the Australian Constitution*, Cambridge University Press.
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- 6 Aroney, N 2009, op cit.
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- 18 *Official Report of the National Australasian Convention Debates, Adelaide*, Government Printer, 1897, p. 17 (Resolutions of Edmund Barton) and p. 338 (comments by John Alexander Cockburn).
- 19 Australian Bureau of Statistics 2010, *Australian Demographic Statistics, September 2010*, Cat. No. 3101.0.
- 20 Australian Bureau of Statistics 2000, *Australian Social Trends*, 2000, Cat. No. 4102.0; See also Forster, C 2004, *Australian Cities: Continuity and Change*, 3rd edn, Oxford University Press, pp. 2–13.
- 21 Hugo, G 2001, 'A Century of Population Change in Australia' in Australian Bureau of Statistics, 2001: *Year Book Australia*, No. 83, Cat. No. 1301.0, Canberra, p. 8; See Australian Bureau of Statistics 2007, *Australian Social Trends*, 2007, Cat. No. 4102.0, 'Migration: Permanent Additions to Australia's Population'.
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SECTION

2.0

# Critical interdependencies

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## 2.1

# The culture of Commonwealth and state relations

## Jennifer Menzies



Jennifer Menzies is an Adjunct Senior Research Fellow at the Centre for Governance and Public Policy at Griffith University and a member of the Commonwealth Grants Commission. She has over 20 years' experience in public administration and public policy. She was a senior executive in the Queensland Department of the Premier and Cabinet, including holding the position of Cabinet Secretary from 2001 to 2004. Jennifer was the inaugural Secretary for the Council for the Australian Federation. She publishes in the area of intergovernmental relations, federalism and caretaker conventions.

The focus of much debate on Commonwealth and state relations is usually from the perspective of the Commonwealth, with the states and territories coming off the worst in any struggle around funding and responsibility. This chapter identifies the roles that innovation and experimentation can play in a modern federation, and it seeks to unpick some of the uncritical thinking about the impacts of the dominance of the Commonwealth in our Federation. With an outdated Constitution and continuing Commonwealth confusion about its role in the Federation, it is timely to explore new ways of positioning the Commonwealth to collaboratively support the states in delivering the services that fall under their jurisdictional responsibility.

American scholars have identified the value of a 'learning' and 'leading' role for a central government. The role is to acknowledge and support states and territories to remain laboratories for service delivery experimentation and innovation. It reduces the conflict arising from centrally imposed goals, based on compliance and penalty, on subnational jurisdictions.

This chapter recommends the exploration of a truly federal culture, which would reduce the rancour in Commonwealth and state relations, and work towards a new model to harness the creativity and expertise of all levels of government in Australia.

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## Not all wisdom resides at the centre

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There are many benefits in being in a federation, not the least being the capacity for policy innovation and tailoring local services for local communities.<sup>1</sup> Yet, as a nation we have become bland homogenisers and turned our backs on the benefits of diversity inherent to a modern federation. We strive to fit all our states and regions into a one-size-fits-all national policy approach. In the process we ignore the changing settlement patterns and demographics that show the emerging regional differences across the nation.

How did we become so bland? Social activists, who value difference and diversity within their own organisations, become the first to call for a national approach to program or service delivery. Over time, the states have found themselves shoehorned into the role of the untrustworthy little brother of the Federation, with the paternal intervention of the Commonwealth Government required to pull them back into line if they head off in a new direction. Sticking up for the states in the Federation is an endangered exercise where in the media and popular thinking 'national' equals 'good', but state-based differences are characterised as parochial or vested interests.

Having been through the annual round of that festival of football where state competes against state, it is hard to accept that the 80,000 NSW supporters cheering the Blues to victory believe territorial identification is dead. In Australia, the states and territories do differ from each other. Some states have a younger population, others a greater share of immigrants or indigenous Australians. They are at different stages of development. Western Australia and Queensland are building the cultural institutions, ports and transport infrastructure that were put in place in Sydney and Melbourne more than a century ago when those cities became wealthy through the discovery of gold.

The drive for homogenisation overlooks the important role that policy innovation and experimentation have played in Australia's public life. Our reputation as a laboratory for democratic practice comes from state-based innovation such as South Australia's enfranchisement of women voters in 1895 and the introduction of the secret ballot

in Tasmania, South Australia and Victoria in 1856. More recently, anti-discrimination legislation, carbon emission trading schemes, Casemix funding of public hospitals and climate change adaptation innovations have all been initiated by the states.

The states and territories have many legitimate concerns about their role in the Federation and the loss of federalist values through centralisation and Commonwealth dominance. This chapter seeks to unpick some of the uncritical and unconscious thinking that has emerged around Australia's federal system and to reassert the case for diversity and difference.

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## The culture of the centre

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Commonwealth and state relations have evolved into an unequal relationship. Through a combination of High Court decisions in favour of the Commonwealth Government and the loss of direct revenue-raising capacity by the states, the Commonwealth has reached far beyond its constitutional role to encroach into areas of state jurisdictional responsibility. This power has driven a lot of behaviours from the Commonwealth towards the states, and has allowed national governments to override state sovereignty and downplay the federal elements of our political life.

In Australia, the Commonwealth Government has been a poor investor in resources and structures to manage multilevel governance.<sup>2</sup> There is no federal culture within the Commonwealth and there is an ad-hoc approach to engaging with the states depending on the agenda of the Prime Minister of the day. In contrast, Canada, a comparable federation to Australia, invests heavily in resources to manage the relationship between the federal and provincial governments. Its central agency, the Privy Council Office (PCO), has a custodial role in managing these relationships. As well as having a dedicated Minister of Intergovernmental Affairs, the PCO offers advice on intergovernmental matters including “the evolution of the federation and Canadian unity”.<sup>3</sup>

This lack of a comparable federal consciousness in Australia manifests in many ways. The first is that the Commonwealth, both at the bureaucratic and political level, see any funding to states and territories as ‘their money’ rather than the nation's, and that the states’ sovereignty and accountability mechanisms can be overridden with the Commonwealth having the right to ‘oversee’ how the states spend it.<sup>4</sup> This was reinforced by the *Auditor-General Amendment Bill 2011*, which expanded the role of the federal Auditor-General to “follow the money trail” as if the state parliaments and auditor-generals were inadequate.<sup>5</sup>

The states and territories often characterise their dealing with the Commonwealth as a culture of dismissal. Newly elected Premiers are shocked at attending their first Council of Australian Governments (COAG) meeting to find their attempts to make a serious contribution are often dismissed, as are their attempts to make a broader contribution to nation building.<sup>6</sup> Ministers received more shock treatment in the May 2014 Federal Budget when the future growth funding for schools and hospitals suddenly disappeared. It now appears that National Partnership Agreements, and the funding formulas agreed within them, are no longer binding when the Commonwealth has a change of plan. This sense of dismissal permeates joint programs and initiatives.

As the Royal Commission into the Home Insulation Program has shown, advice from state administrations on the regulatory inadequacies on the rollout was not welcomed by their Commonwealth counterparts. The same cycle was repeated in 2009 when

the proposed model for the Rudd Government's health reforms was released to the media before the details were provided to the states and territories, despite the states and territories being responsible for the implementation of the reforms.<sup>7</sup>

Many of these manoeuvres are supported by the dark arts of divide and conquer, ambush, veto and withhold information.<sup>8</sup> The Commonwealth frequently uses coercive practices, mainly based on its funding superiority, to get state and territory sign-up to a proposal. Commonwealth officials acknowledge the many games they play in intergovernmental negotiations and their propensity to enter into negotiations with a preconceived outcome.<sup>9</sup>

State and territory disagreements are characterised by the Commonwealth as self-serving and protecting vested interests. There seems little capacity within our federal system to manage the legitimate concerns of the states without them being cast as spoilers or interested only in parochial outcomes. In this, the media uncritically supports the Commonwealth interests. Most political commentary is generated by journalists based in Parliament House in Canberra. They have a world view forged by constant interaction with federal ministers and senior Canberra bureaucrats. The media seems only interested in reporting Commonwealth and state relations in terms of their blockage of 'national' reforms or in depicting their behaviour as mendicant. Reporters tend to perpetuate the Commonwealth-centric view that if left to themselves, the states and territories would only squabble, so the Commonwealth must come in 'over the top' to settle the issue.

These petty irritations and gamesmanship mask a deeper problem. The value of a federation is the scrutiny and contribution that multiple governments can make to solving problems and implementing new programs. For many issues, the states and territories are closer to the impacts and implications for their constituents, yet little credence is given to their larger expertise in these areas. An untested assumption is that if the Commonwealth undertook service delivery, such as running hospitals, it would be done 'better'. In Australia, we have unconsciously accepted that a national approach is inherently superior to seven state-based approaches. In this context, former Queensland Premier Beattie wrote of his desire to see a "more mature approach from the Commonwealth to ensure the strengths of our federal system of government are used more effectively".<sup>10</sup>

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## The problem of Commonwealth role confusion

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In 1901, Australia's Constitution set out what was a meaningful role for the new Commonwealth Government. This list of responsibilities now bears no resemblance to the complex intermingling of roles, responsibilities and funding agreements that characterise Commonwealth and state relations. What has remained consistent is the role of the states with their focus on service delivery. The Commonwealth's role has become unstable and more so in recent years. Successive Prime Ministers have campaigned on issues under the jurisdictional control of the states and territories to show their commitment to the bread and butter issues of interest to most people. Now when the government changes federally, so do the areas for attention by the Commonwealth. Federal public servants have to scramble to get across new policy areas and programs as the reach of the Commonwealth becomes even more extensive.

This seesawing role has, in the past, reached absurd levels. As Prime Minister, Kevin Rudd floated a Commonwealth takeover of the health system. He wanted to quarantine the states' Goods and Services Tax (GST) revenue to pay for his reforms. He then settled for the Commonwealth being the 'dominant funder' of public hospitals.<sup>11</sup> His successor, Tony Abbott, was an early advocate of the Commonwealth takeover of the health system, before announcing via this year's Budget that "the states were responsible for public hospitals and schools and would have to take on more responsibility for those areas of government".<sup>12</sup>

While the Commonwealth twists itself endlessly around what role it should have in the health system, the states keep building hospitals, running community services, managing infectious diseases and rolling out health promotion activities. The Commonwealth can cherry pick when and what it would like to be involved in, but the states have no choice.

As the Commonwealth constantly dips into issues under the jurisdictional responsibility of the states, its approach to managing that relationship is also unstable. The approach runs from the cooperative to the coercive, from benign neglect to micro-management of state-based programs. This confusion about the Commonwealth Government's role means there is no shared understanding in Australia of what kind of federation we are, and it leaves the relationship between the Commonwealth and the states under constant renegotiation.

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## Finding a viable role for the Commonwealth

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Recently, the Commonwealth cast itself as the great 'fixer' of Australia's federal system. Using its financial advantage, money has been thrown at problems that the states have 'failed to fix'. The many recent implementation failures of the Commonwealth may allow us to draw a line under this fallacy. The implementation of national, complex programs should not be the role of the Commonwealth, according to Labor Senator Mark Bishop, who recently claimed in relation to the National Rental Affordability Scheme, "it seems to me that the ability to properly design programs that are so complex is something the [Commonwealth] public service doesn't really have the capacity or expertise to do".<sup>13</sup>

The question to ask is what is a meaningful role for the Commonwealth Government in the early 21st Century? Part of the answer will come through the *White Paper on the Reform of the Federation* in which the split of the roles and responsibilities between the Commonwealth and the states is one of the terms of reference. The white paper will allow consideration to be given to identifying what is genuinely an issue of national importance, what requires collaboration and coordination, and what should be left to state or local jurisdictions.

The establishment of the split of roles and responsibilities will present some options for the Commonwealth to reconceptualise its role. For areas in which it has clear jurisdictional responsibility, such as defence, immigration and foreign affairs, the Commonwealth Government remains responsible for all policy development and program funding. With areas of concurrent responsibility and overlap such as counter-terrorism and disaster management, the opportunity will be to develop best practice collaborative models that recognise the principle of subsidiarity and make use of the expertise of different levels of government. For the third sphere of Commonwealth activity, the overlap and duplication of services for which the responsibility sits with the states, including health, policing and education, there is scope to reconceptualise the role of the Commonwealth within the Federation.

If we accept that the states remain the laboratories of service delivery experimentation and innovation, then, as American scholar Shelley Metzenbaum has identified, federal agencies need to assume both a learning role and a leading role.<sup>14</sup> By this, she means the national government adopts a different leadership role – one of identifying what works, disseminating findings, and helping with the transfer of promising practices and outcomes. This would mean shifting the emphasis from accountability and oversight to proactively generating “outcome-focused, evidence-based insights”.<sup>15</sup>

How could this apply in Australia? Instead of an intergovernmental relationship based on compliance and penalty, there is the potential to develop a relationship built upon developing collective solutions to widespread problems. An example Metzenbaum uses is the valued relationship between the National Highway Traffic Safety Administration (NHTSA) and the American states. The NHTSA collects information about traffic injuries and fatalities. It also collects information about behaviours and conditions that might explain those events, and state government programs that address those concerns.<sup>16</sup> The NHTSA is well regarded by the states because of its value add. The federal organisation collects and analyses data from across states to understand the patterns of problems. Based on this evidence, it identifies strategies to reduce fatalities and injuries as well as funding the testing of new strategies.<sup>17</sup> The NHTSA prioritises returning knowledge to states and creates an environment “that continually harvests and re-sows the lessons of state experience”.<sup>18</sup>

Adopting elements of this approach in Australia has the potential to move us beyond the cycle of conflict that characterises our intergovernmental relations when the centre seeks to impose their goals on subnational jurisdictions. For the states, the additional costs imposed on them to adopt national policy goals are never acknowledged. State leaders are elected with their own service delivery commitments and their budgets are aligned to meet those commitments. New Commonwealth goals displace those commitments, and states are often left with the long-term funding responsibility when the Commonwealth ceases investment in a particular program. A transition from compliance to identifying productive and innovative approaches to problems establishes a more ‘federal’ role for the Commonwealth. It would allow the Commonwealth to exercise leadership through promoting experimentation and achievement, and disseminating best practice across jurisdictions.

Such an approach by the Commonwealth would help unleash some of the advantages of being in a federation, which are currently starved of oxygen in Australia. It would allow us to:

- Value the diversity and competition inherent in a federal system;
- Encourage the spread of innovation across jurisdictions;
- Allow for the development of local services for local communities; and
- Reduce the rancour that emerges when federal relations become confused, conflicted or coercive.

It would also allow us to develop a ‘federal’ culture in which all levels of government could contribute to nation building by harnessing the creativity and expertise of all levels of government.

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## 2.2

# The legality of federal government expenditure

Professor Anne Twomey



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The Commonwealth Government has long claimed the power to spend money on any subject it chooses, regardless whether it falls within its legislative powers. It has based this claim on the notion that it should be able to do anything that is for the nation's benefit, and that it should have all the powers befitting a national government, such as those of the United Kingdom (UK) Government.

History shows that this was never intended. The Commonwealth's capacity to spend was always intended to be limited, with the expectation that a resulting large surplus would be transferred to the states to fund their greater spending responsibilities.

From the 1970s into the 2000s, the Commonwealth built up a massive edifice of spending based upon little more than an aspirational view of the extent of its executive power and the hope that no court would be willing to knock it down. Spending, which had previously validly been made by grants through the states, was instead directly applied for the construction of local roads, programs in schools, regional development projects and massive pork-barrelling pre-election funding of sports grounds, surf clubs and community facilities. The Commonwealth treated the revenue that it received as its own money to use for maximum political and electoral benefit.

In a series of cases brought by individual taxpayers from 2009 to 2014, the High Court partially restored the original intent of the Constitution by making it clear that the Commonwealth:

- Can only undertake direct spending upon matters within its allocated legislative powers; and
- For the most part, actually needs to legislate so that there is parliamentary authorisation of the expenditure of public money.

The Commonwealth can still, of course, validly make grants to the states to spend money on other matters, but that requires a return to cooperative federalism.

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## The constitutional framers' intent: Keeping the surplus out of the hands of the Federal Treasurer

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In the 1890s, the framers of the Constitution faced a dilemma. On the one hand, they intended to create a small central government of limited powers, leaving most functions, including the most expensive responsibilities such as health and education, to the states. On the other hand, for political reasons, they proposed to allocate the main form of revenue, customs and excise duties,<sup>1</sup> to the sole control of the Commonwealth.

It was clear to the framers of the Constitution that a substantial amount of Commonwealth revenue would have to be transferred to the states. The constitutional convention debates of the 1890s showed that the framers were concerned that a large surplus inevitably leads to a "system of waste and extravagance"<sup>2</sup> and gives rise to a temptation that should be kept "out of the hands of the Federal Treasurer".<sup>3</sup> They therefore did not want to leave the Commonwealth in control of the excess revenue that it would receive.

The framers decided that the Commonwealth should be limited to spending upon its own functions and that all the rest of its revenue – the surplus – should be paid to the states.<sup>4</sup> The question was how to avoid any risk that the Commonwealth would gobble up the surplus in profligate spending, reducing the amount to be transferred to the states.

Some, such as the Premier of Tasmania, Sir Edward Braddon, thought there should be a fixed requirement that the Commonwealth could only spend one-quarter of its revenue from customs and excise duties, and that the rest had to be paid to the states. Such a requirement was included in the draft Constitution, but later whittled down in its application to 10 years, after which, it could be removed by the Commonwealth Parliament,<sup>5</sup> which it did as soon as it was able.<sup>6</sup>

Others, such as Sir John Downer, thought it unnecessary to impose any additional limits on Commonwealth expenditure because it was already achieved by “the limitation of the subjects of jurisdiction given to the Commonwealth, and the impossibility of extravagant expenditure resulting from the limitation of the area of legislation and action of the Federal Parliament”.<sup>7</sup> Sir John Downer was relying on the fact that under section 81 of the Constitution, the Commonwealth could only appropriate money “for the purposes of the Commonwealth” and not for any other purposes. The Commonwealth therefore needed to have been allocated legislative power on a subject in order to spend on it.

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## Commonwealth expenditure and grants to the states

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It was well accepted in the first half of the 20th Century that the Commonwealth had limited spending powers and that the only way it could spend money outside of the subject matters granted to it by the Constitution was to make grants to the states under section 96 of the Constitution. For example, Justice Fullagar noted in a 1957 case that Commonwealth funding for roads could only be made through section 96 grants because the “Commonwealth had, of course, no power directly to appropriate moneys for application to the making or maintenance of roads”.<sup>8</sup>

Section 96 stands as a clear indication that the Commonwealth cannot expend money in relation to some subject areas, unless it makes grants to the states to do so.<sup>9</sup> In 1975, Justice Mason noted that the presence of section 96 “confirms what is otherwise deducible from the Constitution, that is, that the executive power is not unlimited and that there is a very large area of activity which lies outside the executive power of the Commonwealth but which may become the subject of conditions attached to grants under section 96.”<sup>10</sup> Section 96 would otherwise be superfluous if the Commonwealth had the power to appropriate money with respect to any subject matter.<sup>11</sup> These points have most recently been reiterated by the High Court in the 2012 case, *Williams No 1*, concerning the school chaplaincy program.<sup>12</sup>

The Commonwealth Government bridled against these restrictions, arguing that it should have all the powers befitting its status as a national government and that it should be able to spend upon any purpose it regards being for the benefit of the nation, regardless of the powers allocated to it by the Constitution.

The Commonwealth therefore began, particularly in the 1970s under the Whitlam Government, to appropriate and spend money on subjects that were not within its constitutional powers. It relied upon the circular argument that the mere fact that the Commonwealth Parliament had decided to appropriate money for a purpose was enough to make it a ‘purpose of the Commonwealth’. This would, of course, render the phrase in section 81 of the Constitution superfluous, as all appropriations, by virtue of the fact that they were made, would on this reasoning be for the ‘purposes of the Commonwealth’. Nonetheless, some Justices of the High Court appeared to accept

this argument.<sup>13</sup> These judges were influenced by both the concern that otherwise many past appropriations would be invalid<sup>14</sup> and the need for the Commonwealth to fund worthy causes, such as exploration and scientific research.<sup>15</sup>

A constitutional challenge to the validity of the appropriation for the Whitlam Government's *Australian Assistance Plan* resulted in an equivocal outcome:

- Three Justices upheld the validity of the appropriation;
- Three Justices held that it was invalid, either because it was not an appropriation for the “purposes of the Commonwealth” or because the executive action implementing the scheme went beyond the Commonwealth’s power; and
- The seventh Justice held that the states had no standing to challenge an appropriation.<sup>16</sup>

There were obvious policy problems with permitting constitutional challenges to appropriations, as holding an *Appropriation Act* to be invalid, especially if this occurred long after it was passed, could cause serious financial problems and result in economic instability.

The result of the case was that the *Australian Assistance Plan* survived, even though there was no majority decision about the Commonwealth’s appropriation powers. While the Fraser Government retreated to the traditional and clearly valid practice of funding matters outside its powers through grants to the states, this practice was gradually eroded during the time of the Hawke and Keating governments.

It was the Howard Government, however, that most starkly revived the Whitlamesque tactics of direct funding of local government, community groups, schools and other bodies, rather than making grants through the states. This was regarded as giving the Commonwealth electoral advantages by being seen as directly responsible for all beneficence, which was then proclaimed loudly in a proliferation of signs on roads and schools. It was also a tactical move to build up direct funding to such levels that it would discourage the High Court from striking down the validity of its spending due to the widespread damage it would cause.

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## The imposition of limits on the Commonwealth’s expenditure power

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Limits on the Commonwealth’s expenditure power have been progressively imposed in a series of three cases in the High Court:

1. *Pape v Federal Commissioner of Taxation (the Pape case)*;
2. *Williams v Commonwealth No 1 (Williams No 1)*; and
3. *Williams v Commonwealth No 2 (Williams No 2)*.

### *The Pape case*

The first case was a challenge brought by Bryan Pape in 2009 to Commonwealth grants made to taxpayers as a means of stimulating the economy during the Global Financial Crisis (GFC).<sup>17</sup> Rather than making the grants to the states with the condition they are paid out immediately to taxpayers, the Commonwealth wanted to gain maximum electoral advantage from sending out the cheques with a letter from the Treasurer showing who was responsible for this gift to taxpayers.

Four Justices upheld the payments on the basis that they were a short-term response to a national economic emergency resulting from the GFC.<sup>18</sup> The payments fell within a Commonwealth power, sometimes known as the ‘nationhood’ power, to “engage in enterprises and activities peculiarly adapted to the government of a nation and which cannot otherwise be carried on for the benefit of the nation”.<sup>19</sup>

The critical aspect of *the Pape case*, however, was that all the Justices held that the power to appropriate money in section 81 of the Constitution did not support the expenditure of the money. The Commonwealth needed a separate power to support expenditure.<sup>20</sup> This shifted the question away from whether an appropriation was for the “purposes of the Commonwealth” to whether the Commonwealth had a head of power to support the expenditure of money on particular programs. By shifting the question in this way, the Court avoided the problem of Appropriation Acts being held invalid and whether anyone had standing to challenge them. Instead, the battlefield moved to whether the Commonwealth had validly authorised the expenditure of the money.

Members of the Court also started raising issues of federalism, which had long been neglected, particularly in their expansive interpretations of Commonwealth legislative powers.<sup>21</sup> Chief Justice French, while accepting that the nationhood power applied in this case, noted that it “cannot be invoked to set aside the distribution of powers between the Commonwealth and the states”.<sup>22</sup>

Justices Hayne and Kiefel observed that the federal system is one of separately organised polities of which the Commonwealth is a government of “limited and defined powers”.<sup>23</sup> They pointed out that the Commonwealth’s executive power “is the executive power of a polity of limited powers”.<sup>24</sup>

Justice Heydon added that “the Commonwealth Government, while in one sense a ‘national government’, is only the central government in a federal nation”.<sup>25</sup> This is in stark contrast to the Commonwealth’s view of itself as being the dominant government in Australia, having the full executive powers befitting the status of any national government.

As a majority of the Court ultimately upheld the validity of the payments in *the Pape case*, the Commonwealth seems to have assumed that in the end the High Court would never strike down its expenditure, particularly as its edifice of direct expenditure was now so immense and complex. In evidence to a parliamentary committee, an officer of the Department of the Prime Minister and Cabinet stated that having taken into account the High Court’s judgment in *the Pape case*, “the Commonwealth remains able to make grants under its general powers in the Constitution”.<sup>26</sup>

The Commonwealth Government appeared to consider that it had a general power to spend on anything that was for the national benefit, and that this would be supported by its executive power, without the need for legislation. The Commonwealth was wrong on both points, as the two subsequent Williams cases show.

### Williams No 1

Ron Williams challenged the Commonwealth's expenditure on a chaplaincy scheme for schools. While his real concern was the use of chaplains in public schools, which he regarded a breach of the separation of Church and State, his legal advisers suggested that a more effective challenge would be to argue that there was no legislative head of power supporting the expenditure and that its validity could not rest solely on executive power. The chaplaincy scheme was not supported by legislation. It was purely an administrative and contractual arrangement that governed the expenditure of money that had been appropriated as part of the budget.

The Commonwealth argued that just like any legal person, it had the capacity to spend money on anything, as long as it was the subject of a valid appropriation. In the alternative, it argued that it at least had the power to spend money on anything that *could* have been the subject of a validly enacted law authorising the expenditure, without actually having to enact such a law.

The High Court rejected both arguments. In doing so, it relied upon three essential factors:

1. The principles of federalism;
2. The requirement that the executive be accountable to the Parliament; and
3. The fact that the Commonwealth was spending 'public money' rather than its own money.

#### 1. Federalism

On the federalism front, Justices Gummow, Crennan and Bell expressed concern that a broad Commonwealth expenditure power would mean that the Commonwealth could bypass the need to make grants to the states under section 96 of the Constitution.<sup>27</sup> Justice Hayne noted that grants to the states must not be coercive and may be refused by the states if they do not accept the conditions. If the Commonwealth could make direct grants to bodies under its executive power, the states would get no say and coercive conditions could be attached.<sup>28</sup>

Justices Crennan and Kiefel added that the very presence of section 96 in the Constitution was evidence that the Commonwealth's executive power did not extend so far and that there are large areas beyond the scope of the Commonwealth's executive power.<sup>29</sup> Justices Gummow and Bell even acknowledged that "the conduct of the public school system in Queensland ... is the responsibility of that state".<sup>30</sup>

Justice Kiefel expressed concern that a broad Commonwealth expenditure power would lead it to encroach upon "areas of state operation and thereby affect the distribution of powers between the Commonwealth and the states".<sup>31</sup> Her Honour considered that chaplaincy services in schools were within "the province of the states, in their provision of support for school services".<sup>32</sup>

## 2. Accountability

The Court stressed the importance of parliamentary accountability for expenditure above and beyond the limited scrutiny given to appropriations. It emphasised the scrutiny of the Senate and the need for Parliament to have a role in the “formulation, amendment or termination” of programs for the expenditure of money.<sup>33</sup>

Justice Hayne added that above and beyond constitutional requirements for parliamentary involvement, it would also be “sound government and administrative practice” for programs to be governed by legislation, making them reviewable both within Parliament and outside it.<sup>34</sup> Government programs that are the subject of legislation, rather than being worked out on whiteboards or the back of envelopes, have to be more closely thought through, and publicly justified and defended in both Houses of the Parliament. This means they are more likely to be efficient and better administered than programs based solely on executive fiat.

## 3. Public money

The third point that the High Court made is that the Commonwealth is not spending its *own* money. Rather, it is spending *public* money, and must therefore be more accountable.<sup>35</sup> This point can’t be stressed enough. It is not money that may be used to maximise the political and electoral advantage of the Commonwealth Government (whichever party happens to be in office). It is money raised from the public for the purpose of providing government services and infrastructure to the public at both the Commonwealth and state level. The expenditure should be based upon providing for those needs, wherever they are situated, not upon desires for self-aggrandisement or for maximising the electoral advantages of pre-election pork-barrelling.

### The Commonwealth response

The Commonwealth’s response was swift, brutal and rash. Rather than assessing the different types of programs that currently relied upon the executive power and whether they could be made the subject of valid legislation or were better dealt with by way of grants to the states, the Commonwealth simply legislated to validate them all in a job lot.<sup>36</sup> Its legislation purported to validate past programs and authorise future programs as long as they could be shoe-horned within a list of over 400 programs set out in the regulations to the *Financial Management and Accountability Act 1997* (Cth). The descriptions of these programs are in many cases extremely wide, such as ‘Diversity and Social Cohesion’, ‘Domestic Policy’ and ‘Regional Development’.<sup>37</sup>

Little or no consideration seems to have been given as to whether each particular program was supported by a head of Commonwealth legislative power. Certainly this was not addressed in the very brief debate while the Bill was rushed through Parliament. Again, the assumption was made by the Commonwealth Government that it could still spend on anything that it regarded beneficial for the nation – but that there must now be some kind of general legislation to support it. The principles, upon which the High Court had relied, such as federalism and the need for parliamentary accountability, were simply ignored.

One of the many programs validated and authorised was the chaplaincy program. Ron Williams again took the matter to the High Court.

### *Williams No 2*

Ron Williams challenged the chaplaincy program on the ground that the Commonwealth had no legislative power to support spending upon chaplaincy in schools. He also challenged the validity of the Commonwealth legislation that sought to validate all the Commonwealth's executive expenditure programs on the ground that it wasn't supported by a head of Commonwealth legislative power either.

The Commonwealth argued that the chaplaincy program was supported by:

- A constitutional provision that allows the Commonwealth to make laws with respect to 'benefits to students'; and
- Its power to make laws with respect to 'trading corporations' (on the ground that Scripture Union Queensland, to which the money had been paid, was a trading corporation).

The High Court unanimously dismissed both arguments. It held that neither power supported Commonwealth legislation authorising spending upon the chaplaincy program.<sup>38</sup>

The Commonwealth also sought to overturn *Williams No 1*, contending that:

- The principles in the case were not carefully worked out over a series of cases;
- There had been insufficient argument on the issues;
- The reasoning did not give a single answer about when legislation is required to support expenditure; and
- The case had "led to considerable inconvenience with no significant corresponding benefits".<sup>39</sup>

The High Court, however, dismissed these complaints and reinforced its judgment in *Williams No 1*.

The Commonwealth argued again that its power to spend was not constrained by the federal distribution of powers in the Constitution. If it was, however, it argued that it still had an executive power to spend on all matters that are reasonably capable of being seen as of national benefit or concern, being those that "befit the national government of the Federation".<sup>40</sup> It then argued that chaplaincy is "reasonably capable of being seen as a matter of national benefit or concern" and that expenditure on the program was therefore valid.

The Court responded by noting that on this reasoning, practically anything would fall within the Commonwealth's spending powers.<sup>41</sup> It concluded that the Commonwealth's argument was based upon the false premise that "the executive power of the Commonwealth should be assumed to be no less than the executive power of the British Executive".<sup>42</sup> The Court stressed that Australia is a federation, not a unitary state, and that the Commonwealth's powers are therefore limited. It concluded:

"This assumption, which underpinned the arguments advanced by the Commonwealth parties about executive power, denies the 'basal consideration' that the Constitution effects a distribution of powers and functions between the Commonwealth and the states. The polity which, as the Commonwealth parties rightly submitted, must 'possess all the powers that it needs in order to function as a polity' is the central polity of a federation in which independent governments exist in the one area and exercise powers in different fields of action carefully defined by law. It is not a polity organised and operating under a unitary system or under a flexible constitution where the Parliament is supreme. The assumption underpinning the Commonwealth parties' submissions about executive power is not right and should be rejected."<sup>43</sup>

This has hopefully once and for all eliminated the Commonwealth's premise that as a 'national' government it can spend on anything it deems in the national interest or for national benefit.

Despite the Commonwealth's provocation, the High Court was ultimately quite restrained in its judgment in *Williams No 2*. It did not strike down the whole of the Commonwealth's scheme to validate and authorise the hundreds of Commonwealth spending programs. Instead, it chose to read the relevant provisions so that they only operated in relation to those spending programs that fall under a Commonwealth legislative power.<sup>44</sup> The law is therefore likely to be effective in supporting some of the listed programs, being those that clearly fall within a head of Commonwealth legislative power, such as external affairs, defence or immigration. However, this leaves uncertain the validity of Commonwealth spending upon a large range of other programs that do not appear to fall under its legislative power.

Professor George Williams observed that this includes programs concerning matters such as "drought assistance, local government, community legal centres, energy efficiency, community safety, affordable housing, sport and the arts" as well as education programs such as those concerning "early childhood education, school support and the Australian baccalaureate".<sup>45</sup>

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## Implications for cooperative federalism

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In the Pape and Williams cases, the High Court made it clear that the Commonwealth is a polity of limited powers within a federation made up of independent governments. The Commonwealth does not have the power to spend on matters outside the powers allocated to it by the Constitution, unless it does so by grants to the states under section 96 of the Constitution. It also made clear that these grants must not be coercive and the states must have the option to reject them. What, therefore, are the consequences of *Williams No 2*?

As the High Court did not strike down the provisions of the *Financial Management and Accountability Act* that purport to authorise Commonwealth expenditure, these provisions may continue to operate in relation to those spending programs that fall within the Commonwealth's powers.<sup>46</sup> For other spending programs that rest on a more dubious basis, the Commonwealth might rely on the fact that it is very rare for anyone to challenge the validity of its spending programs and it might take the view that it should continue with spending as usual until brought to book by more litigation. This would be a narrow short-term approach, but consistent with previous Commonwealth practice.

A more sensible approach by the Commonwealth, however, would be to reassess its expenditure programs. Which ones fall within its powers? Which ones fall within national priorities and ought to be the subject of cooperation between the Commonwealth and the states? Which ones are really matters for the states to deal with? What economic advantages can be achieved by a single level of government dealing with an issue rather than the duplication of policy, administrative and accountability roles? What, in short, is best for the long-term interests of the people of Australia, rather than the short-term interests of political parties in government?

### *White Paper on the Reform of the Federation*

The reconsideration of these expenditure programs should occur within the wider context of the reform of the federal system, and Commonwealth and state financial relations. The terms of reference for the Commonwealth's proposed *White Paper on the Reform of the Federation* raise some hope that these issues will be addressed comprehensively. If it can be achieved, the next great productivity reform for Australia will be the reform of the federal system to remove inefficiencies arising from duplication, excessive administrative burdens, over-centralism and lack of competition.

The Prime Minister, in announcing the terms of reference of the white paper, recognised that a major part of the problem with the federal system is that the Commonwealth has become increasingly involved "in matters which have traditionally been the responsibility of the states and territories" and that states and territories have become increasingly reliant on revenue collection by the Commonwealth.<sup>47</sup>

The white paper is to consider, within the constitutional framework:

- The practicalities of limiting Commonwealth policies and funding to core national interest matters, as typified by the matters in section 51 of the Constitution;
- Reducing or, if appropriate, eliminating overlap between local, state and Commonwealth responsibility or involvement in the delivery and funding of public programs;
- Achieving agreement between state and Commonwealth governments about their distinct and mutually exclusive responsibilities and subsequent funding sources for associated programs; and
- Achieving equity and sustainability in the funding of any programs deemed the responsibility of more than one level of government.<sup>48</sup>

While laudable aims, reforms of these kind have been promised many times before. Almost every Prime Minister has some kind of 'new federalism' policy that gives rise to much sound and fury but ultimately signifies nothing.

Kevin Rudd swept to power with great plans to end the blame game and reform the federal system. Significant changes were made to simplify and consolidate grants, only to be undone almost immediately by the creation of 'national partnerships', which reinvented the previous burdens, duplication and encumbrances. Hence it is difficult not to be cynical about new promises of federalism reform.

However, nothing can be achieved without trying. The key difference will be whether there is sufficient willingness to tackle the issue of federal financial relations. Returning responsibilities to the states is a hollow reform if relevant funding (or means of funding) does not accompany the responsibilities. As the High Court stressed in *Williams No 1*, it is 'public money' that is in question, not the Commonwealth's money. An assessment needs to be made of the general cost of different responsibilities, such as health and education, as a proportion of gross domestic product (GDP), and access to the same proportion of overall revenue must be allocated to the level of government that holds the responsibility. Whether this should be done by reallocating sources of tax revenue to different levels of government (which enhances responsibility for the balance between revenue raising and expenditure) or whether it is achieved by tax sharing (because it is often more economically efficient for a tax to be imposed and administered centrally) is a matter for further discussion.

For the federal system to work efficiently, it is imperative that the level of government responsible for fulfilling a function has access to the revenue needed to perform that function adequately without needing to rely upon the goodwill of another level of government. The framers sought to achieve this outcome by limiting the Commonwealth's spending to its responsibilities and allocating the surplus to the states. This system failed within 10 years of federation. One can only hope that the outcome of the *White Paper on the Reform of the Federation* is a more effective system that has a longer and more productive life.

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## 2.3

# Regulatory setting within the Australian Federation

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The historical origins of Australia, first as colonies, then as self-governing states, and finally as a Federation, have engendered the development of a cooperative federalism that governs Australia today. This concept of cooperative federalism, where national, state and local governments interact cooperatively and collectively to solve common issues and concerns, defines the regulatory setting in Australia.

Both shaped by and constrained by federalism, Australia's regulatory framework illustrates how regulation in the 21st Century is the interaction of state and federal levels of government regulating the myriad of activities that occur in Australia today. Some activities, such as onshore mining, are the regulatory purview of the states, falling squarely within the plenary powers. Other areas, such as immigration and defence fall within Commonwealth regulatory competence. Still others, such as offshore petroleum activities, exhibit regulatory complexities, since both the states and Commonwealth have regulatory jurisdiction over some portion of the activities.

This chapter provides an overview of the regulatory setting within which 21st Century Australia operates. To examine the regulatory setting within the Australian Federation, the chapter firstly examines what regulation means. In doing so, it identifies the many forms of regulation, before settling on the idea of legal regulation. To consider legal regulation in 21st Century Australia, this chapter also provides an overview of the distribution of regulatory power to the Commonwealth and states as conferred by the Australian Constitution and delineated in subsequent judicial decisions.

The chapter then examines the regulatory setting of Australia's Federation today, in particular, the forms of regulation available for cooperative federalism to continue, such as:

- The use of the referral power under section 51(xxxvii) of the Australian Constitution;
- Co-regulation;
- Mirror legislation; and
- Harmonisation of legal frameworks.

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## What does 'regulation' mean?

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The concept of regulation has existed for many millennia. In its broadest sense, regulation can be described as a rule designed to control or govern conduct. The concept of regulation refers to "the broad range of legally enforceable instruments which impose mandatory requirements upon business and the community, as well as those government voluntary codes and advisory instruments for which there is a reasonable expectation of widespread compliance".<sup>1</sup> Governments use regulations as instruments to achieve economic, social and environmental objectives.<sup>2</sup>

Such regulation has existed since early civilisations, including Egyptian, Roman, Greek and Indian civilisations. Indeed, the fundamental basis of civil law, the Justinian Code (also known as Corpus Juris), arose from a collection of fundamental works in jurisprudence issued from 529 to 534 by order of the Eastern Roman Emperor Justinian.<sup>3</sup>

Many forms of regulation occur. Freiburg identifies at least six forms, including:

1. Economic regulation;
2. Transactional regulation;
3. Authorisation as regulation;
4. Structural regulation;
5. Informational regulation; and
6. Legal regulation.<sup>4</sup>

In the context of regulation within the Federation, this chapter will focus on legal regulation as a tool that governments use to govern the conduct of those within the Federation.

The legislative framework established by a state can include either rule-based (prescriptive) or objective-based legislation.<sup>5</sup>

Rule-based regulatory frameworks rely on legislatively entrenched rules to regulate activities. These systems tend to require new rules every time a new regulatory situation arises.<sup>6</sup> In addition, rule-based regulation can lead to regulatory inconsistencies and rigidity, and is prone to creative compliance to adjust to new situations.<sup>7</sup>

Objective-based regulation moves away from detailed, prescriptive rules, instead relying on broadly stated principles or objectives to set the standards by which companies conduct their operations, and the basis for decision-making by public authorities. Under this type of regulation, there is a reference to generalities that express fundamental obligations that the participants should observe.<sup>8</sup> It is often known as objective-based regulation since it seeks to implement the policy objectives using broad principles rather than specific rules.

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## Regulatory setting in the Australian Federation

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Since federation, the regulation of Australian states has been redistributed between federal and state governments. The Australian Constitution enumerates the regulatory powers granted to the Commonwealth Government (head of power). Generally, these powers are enumerated under section 51 of the Australian Constitution. Examples of these powers include:

- Trade and commerce;
- Corporations;
- External affairs;
- Taxation;
- Defence; and
- The incidental power under section 51(xxxix), which allows the Commonwealth to act on matters incidental to an enumerated head of power.

The extent of the Commonwealth's enumerated power has been defined and shaped by over 100 years of judicial interpretation by the High Court. Several notable cases, including *The Engineers Case*,<sup>9</sup> *The Boilermakers Case*<sup>10</sup> and the *Tasmanian Dams Case*,<sup>11</sup> have considered the powers of the Commonwealth and the states. Over the last 110 years, decisions of the High Court have delineated the boundaries of Commonwealth powers, and under the Constitution, considerably expanded the

Commonwealth's powers. The 'incidental power' under section 51(xxxix) of the Constitution, in conjunction with judicial decisions, has increasingly concentrated regulatory control in the hands of the Commonwealth. A recent example of such regulatory control is demonstrated in the shift of the control of employment and industrial relations to the Commonwealth, particularly after the decision in *The Work Choices Case*.<sup>12</sup>

Where there is no enumerated power for regulation by the Commonwealth, the regulation will fall to the states under plenary powers granted by the various state constitutions.<sup>13</sup> Such plenary powers are often referred to as "... to make laws for the peace, welfare and good government of the state". For example, section 2 of the *Queensland Constitution Act 1867* (Qld) authorises the Queensland Parliament to make laws for the peace, welfare and good government of Queensland. Such plenary powers of the states are subject to section 109 of the Australian Constitution, in which if a law of a state is inconsistent with a law of the Commonwealth, the Commonwealth law shall prevail, and the state law, to the extent of the inconsistency, shall be invalid. The states also have the capacity to refer matters to the Commonwealth Parliament under section 51(xxxvii) of the Australian Constitution (the referral power).

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## The Council of Australian Governments

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The Council of Australian Governments (COAG) was established in 1992 to coordinate activities between federal and state governments, and between state governments, to enhance cooperation within the Federation. As a peak intergovernmental forum in Australia, the COAG is committed to making federalism work, with an emphasis on "cooperative working relationships rather than buck-passing and blame".<sup>14</sup>

The COAG's core agenda of making federalism work centres on regulatory reform. To achieve such reform, all members of the COAG agreed that regulation in their jurisdictions should be consistent with the following principles:

1. Prior to regulatory reform or change, a case for action is established;
2. A range of regulatory types is considered for the regulation of the activity, including self-regulation, co-regulation and non-regulation, and their net benefits and costs assessed;
3. The regulator adopts the regulatory option that generates the greatest benefit for the community;
4. Regulation and legislation should not restrict competition unless it benefits the community as a whole and the objectives of the regulation can only be achieved through restriction of competition;
5. Effective guidance should be provided to relevant regulators and regulated parties to ensure the policy intent and compliance requirements of the regulation are clear;
6. The regulation should remain relevant and effective over time;
7. The regulator consults effectively with key stakeholders during all stages of the regulatory cycle; and
8. Government action should be effective and proportional to the issue addressed and the area of regulation.<sup>15</sup>

However, often regulatory frameworks, and their concomitant policy regimes, emerge incrementally over long periods of time to solve largely simple problems,<sup>16</sup> resulting in regulatory frameworks and policies that may be incoherent, inconsistent and imprecise, causing regulatory burden.<sup>17</sup>

To implement the COAG's principles, it is also essential that existing regulatory frameworks impose the minimum burden necessary to achieve the desired regulatory and policy objective.

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## The regulatory burden created by the Federation

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Unnecessary regulation (often known as regulatory burden) has been identified as a critical issue in regulation for the 21st Century Federation.

In 2005-06, a Productivity Commission Taskforce undertook a study on reducing regulatory burden on business. The resulting report, *Rethinking Regulation*,<sup>18</sup> identified that the volume of regulation in Australia has risen dramatically since 1990, with more regulation passed by the Australian Parliament from 1990-2005 than in the preceding 90 years of federation.<sup>19</sup> This has not only increased the complexity of regulation, but also produced regulation of variable quality. Problems with regulation identified by the taskforce included unclear and questionable objectives, excessive reporting requirements, overlap, duplication and inconsistency, and poorly expressed confusing and inconsistent use of terms.<sup>20</sup>

The Productivity Commission undertook a study into regulatory burden in the upstream petroleum sector in 2008-09.<sup>21</sup> The findings of this study correlated with the findings of *Rethinking Regulation*. It identified multiple sources of regulatory burden arising from the complexity of the regulation of offshore resources by state and federal governments. Sources of regulatory burden include:

- Unclear, questionable or conflicting objectives;
- Overly complex regulation;
- Excessively prescriptive regulation;
- Duplication of regulation;
- Inadequate resourcing of regulators (including inexperience or lack of expertise);
- Overzealous regulation;
- Regulatory bias;
- Unwieldy approval and licencing processes; and
- Lack of transparency in regulatory processes.<sup>22</sup>

The nature of Australia's Federation has the potential to exacerbate both the growth in regulation and the burden that regulation creates. Having unclear role definition between spheres of government can cause regulatory overlap, worsening many of the problems that the Productivity Commission identified.

An example of the effect of Australia's federalist regulatory setting is found in the Queensland aquaculture industry. As incomes have increased in Asia, with concomitant declining fishery catches in the region, there is an opportunity for Australia to develop its aquaculture industry. However, a recent review of aquaculture in Queensland found that no new major investments are being undertaken. Many in the Queensland aquaculture industry cite regulatory risk as a significant barrier to new investment. This risk arises because of the complex and lengthy approvals process, which has no certainty of outcome.<sup>23</sup>

The industry exists, like many others (for example, aggregates extraction), in a legislative ‘grey’ area. Queensland does not have dedicated aquaculture legislation. Rather, aquaculture is regulated through a combination of planning, fisheries, environment and food safety regulation, with some of these areas regulated at both state and Commonwealth levels. Various licences, permits and development approvals from both state and Commonwealth governments may be required for aquaculture production, depending on the location, species and production systems. The complexity involved has been cited as killing the industry before it has a chance to emerge.

As the Queensland Competition Authority noted in its report of the Queensland aquaculture industry, the regulatory risks to the aquaculture industry are uneven. If the development potential is large but unrealised because of regulatory barriers, the resulting economic loss is significant. However, if there is little development potential, the downside of regulatory reform is quite small. There will simply be little or no growth in aquaculture production. In this situation, with a potentially large loss from lack of regulatory reform, but minimal loss from regulatory reform followed by market-driven lack of development, it is preferable to undertake regulatory reform.<sup>24</sup>

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## Tools to reduce regulatory burden in Australia’s 21st Century Federation

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A number of regulatory tools can be, and are, used within the Federation to address regulatory burden and align with the COAG’s aim of implementing regulatory principles. The tools include:

- Referral powers;
- Mirror legislation; and
- Legal harmonisation.

### Referral powers

Section 51(xxxvii) of the Australian Constitution allows the states to refer the plenary power it holds for a particular activity to the Commonwealth. This ‘referral’ may also be done by one state on an individual basis.

An example of such referral of power by a single state was the referral of certain industrial relations matters by the Victorian Government to the Commonwealth under the *Commonwealth Powers (Industrial Relations) Act 1996 (Vic)*. By referring industrial relations laws to the Commonwealth, Victoria enabled the Commonwealth *Workplace Relations Act 1996 (Cth)* to apply to its industrial relations.

Referral may also be undertaken by all states in unison to establish Commonwealth regulatory control over an activity. Such collective conferral of power occurred in 2001 at the coaxing of the Commonwealth Government, and was enacted in the *Corporations Act 2001 (Cth)*. It would appear that the Commonwealth holds a plenary power for making laws with respect to corporations under section 51(xx) of the Australian Constitution. However, in the 1990 *Incorporations Case*,<sup>25</sup> New South Wales (NSW) questioned the constitutional validity of the Commonwealth to make laws with respect to corporations under the *Corporations Act 1989 (Cth)*. The High Court held that while section 51(xx) empowers the Commonwealth to legislate with respect to corporations formed within the limits of the Commonwealth, it did not have the power

to regulate the formation of a corporation, and could only regulate a corporation once it had been formed. Since the *Corporations Act 1989* (Cth) regulated the formation of corporations as well as those already formed, the parts of the Act regulating the formation of corporations was invalid.

The Commonwealth eventually obtained the power to regulate all aspects of corporations, including their formation, by persuading the states to refer their powers over incorporation processes to the Commonwealth. Such referred powers are imbued in the *Corporations Act 2001* (Cth).

Similarly, the states transferred regulatory responsibility of credit to the Commonwealth, where regulatory responsibility for credit lies with the *National Consumer Credit Protection Act 2009* (Cth). This referral was achieved on the heels of the Global Financial Crisis, with the states identifying the logic in a single regulatory framework for credit in Australia in an era of increasing electronic credit activities that defy national borders.

### Mirror legislation

Mirror legislation is identical legislation enacted in each state and territory to create nation-wide consistency. This was effectively employed as a regulatory tool within the Federation in the early 1980s to address the complex issue of the regulation of offshore petroleum activities.

When petroleum was first discovered in the early 1960s, the Commonwealth Government grappled with how the regulatory framework should be constituted given there were no enumerated powers for the Commonwealth with respect to natural resources under the Australian Constitution. The solution was the *1967 Petroleum Agreement*. The legal status of the Agreement was articulated in clause 26, with the participating governments acknowledging that, "... this Agreement is not intended to create legal relationships justiciable in a Court of Law but declare that the Agreement shall be construed and given effect to by the parties in all respects according to the true meaning and spirit thereof".<sup>26</sup>

The *Petroleum (Submerged Lands) Act 1967* (Cth) was implemented to give effect to the *Petroleum Agreement*, thereby securing offshore petroleum development without having to resolve the issue of jurisdiction over marine natural resources. This regulatory détente was shaken by the *Sea and Submerged Lands Act 1973* (Cth), in which the Commonwealth claimed jurisdiction over all of Australia's territorial sea.<sup>27</sup> The states challenged this assertion, claiming that the first three nautical miles of the territorial sea were vested with the states for historical reasons.<sup>28</sup>

NSW challenged the constitutional validity of the *Sea and Submerged Lands Act 1973* (Cth) in the High Court in the *Sea and Submerged Lands Case 1975*.<sup>29</sup> The High Court held that under section 51(xxix) of the Constitution, the external affairs power extends to anything that in its nature is external to Australia, including marine boundaries. This meant that the states held no jurisdiction over waters below low water mark.

However, in the interests of cooperative federalism, the states and Commonwealth governments negotiated a settlement of marine boundaries through the *Offshore Constitutional Settlement (OCS)* in 1979. The OCS divided the regulation of Australia's offshore petroleum activities between the states and the Commonwealth Government, with the states regulating the first three nautical miles and the Commonwealth regulating seaward from three nautical miles.

To effectively co-regulate petroleum activities, the states enacted legislation that ‘mirrored’ the *Commonwealth’s Petroleum (Submerged Lands) Act*. However, in 2008, the new Commonwealth Act, the *Offshore Petroleum and Greenhouse Gas Storage Act 2008* (Cth), came into force. No states except Victoria have mirrored the legislation. As such, regulatory burdens and inconsistencies have been identified, as articulated in the 2009 Productivity Commission Report, *Review of the Regulatory Burden on the Upstream Petroleum (Oil and Gas) Sector*.

The case of the Petroleum (Submerged Land) Acts demonstrates how mirror legislation can be ineffective, and how it can even contribute to regulatory burden when amendments are not consistently made over all jurisdictions.

### Legal harmonisation

A tool for regulators that is likely to be increasingly used in the 21st Century Federation is that of legal harmonisation. Rather than requiring exact ‘mirroring’ of legislation, legal harmonisation requires that the principles of the Act and the policy objectives be imbued in the legislation, leaving the jurisdiction to implement the principles in a legislative drafting manner that it sees fit. This harmonisation of laws can be seen in the implementation of EU directives in the European Union. The EU provides Australia with a working example of states (in this instance, nation states) that are directed to implement principles from EU directives, and then implement the principles laid out in the directive in a manner that the nation state sees fit.

An excellent example of this is *Directive 94/22/EC of the European Parliament and of the Council of 30 May 1994 on the Conditions for Granting and Using Authorizations for the Prospection, Exploration and Production of Hydrocarbons* (1994) (the Hydrocarbon Directive). Each EU member state is directed to implement the provisions of the directive, but is able to implement within existing hydrocarbon laws. Directive 94/22/EC was implemented in diverse legislation throughout the EU, including the *Minerals Act* in Poland, the *Petroleum Act* in the United Kingdom, and the *Petroleum Activities Act* in Norway. No two legislative instruments read alike, yet all implement the objectives and principles required under the Hydrocarbon Directive.

In Australia, legal harmonisation has been effectively implemented in offshore petroleum safety. After the Piper Alpha disaster in the North Sea, the regulation of offshore petroleum platform was reformed, with the ushering in of the use of the Safety Case Regime (SCR) as a principle-based form of safety regulation.<sup>30</sup> By 2000, companies and governments alike saw the need for coordinated, national safety regulation. To achieve this objective, the states and the Commonwealth harmonised their legislation to enact the National Offshore Petroleum Safety Authority (NOPSA). While not mirror legislation, the harmonised framework along with Memorandum of Agreements, is extremely effective in enacting the objective of Commonwealth-based safety regulation in offshore petroleum safety.

The COAG has recently attempted to harmonise legal frameworks between states with respect to coal seam gas activities. In its Land Access Work Stream, the COAG Standing Council on Energy and Resources (SCER) (now COAG Energy Council) sought to address the regulatory issues affecting investment in resource exploration and development in natural gas from coal seams, especially land access, community and infrastructure. To address these issues, the COAG Energy Council embarked upon the *Harmonisation of CSG Regulation* project. The project operated from December 2011 to May 2013, with the SCER developing and endorsing a harmonised framework

for CSG. The *National Harmonised Regulatory Framework for Natural Gas from Coal Seams*<sup>31</sup> (the harmonisation framework) puts in place a suite of leading regulatory principles relating to coal seam gas extraction and regulators in the management of coal seam gas. It also ensures that regulatory regimes are robust, consistent and transparent across all Australian jurisdictions.<sup>32</sup>

Although the Commonwealth does not have the necessary enumerated power to regulate coal seam gas extraction in the states, through the COAG Energy Council, the Commonwealth has sought to harmonise the laws relating to coal seam gas in state jurisdictions. Although non-binding, the harmonisation framework has been developed to provide guidance for the states to develop the regulatory tools required for coal seam gas extraction and to ensure this development is managed sustainably.<sup>33</sup>

In the Australian Federation, where relationships between the states and the Commonwealth have at times been contentious, the non-binding nature of the harmonisation framework means that the Commonwealth is not trying to wrest regulatory control from the states. Instead, the states are able to use the framework to develop a regulatory framework that implements the COAG's principles of good regulation for an activity in which some states have less competency than others.

Non-binding legal harmonisation of principles associated with the regulation of activities that occur in multiples states may become an increasingly useful tool to implement the principles of good regulation that the COAG developed, reduce regulation, and to continue the spirit of cooperative federalism.

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## Where will it all end?

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This chapter has identified the regulatory tools that will be increasingly implemented in the new millennium to effectively regulate in the Australian Federation. Yet there are still so many areas that require attention. In the area of property, one of the fundamental economic drivers in Australia, there have been some major reforms. It took over 30 years, but finally Australia has a national personal properties security regulatory framework under the *Personal Properties Securities Act 2009* (Cth). Similarly, a *National Electronic Conveyancing System* was implemented at the initiative of the COAG to provide a single electronic conveyancing system for use throughout Australia. Yet there still remain eight separate land title jurisdictions. While there have been some attempts to create a national Torrens title system, there is yet to be a single system of Torrens title. Perhaps one answer is the harmonisation of Torrens title legislation in the different jurisdictions. Another answer may be that all states mirror their Torrens title legislation similar to the mirroring of Petroleum (Submerged Lands) Acts in each of the states. Another possibility is the conferral of powers relating to the regulation of land title to the Commonwealth.

Whichever method is used, there exists the capacity to create a single land title jurisdiction to reduce regulatory burden and principles of regulation set down by the COAG. However there is one important and necessary component missing – cooperation.

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## Conclusion

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The political will for regulatory cooperation is essential for regulation in Australia's 21st Century Federation. Without cooperation, the tools for efficient and effective regulation in Australia will exist, but they will not be used to continue the tradition of cooperative Federalism.

As this chapter has illustrated, so many times states have challenged the Commonwealth's power to legislate with respect to certain matters. In some areas, such as offshore petroleum regulation, such a state/Commonwealth divide has created a complex regulatory framework that has been the subject of numerous reports and responsible for the Montara well blowout and oil spill. Without cooperation between various levels of government, there will only be greater legal complexity and increased regulatory burden.

There are tools to address this. While mirror legislation is a tool that is available, the experience of offshore petroleum demonstrates that in a complex regulatory framework, this can be difficult to maintain and may indeed lead to poor regulation. The referral power is available to states, although this tool is little used, as many states don't want to lose control over the regulation of areas, particularly where there may be economic benefits of retaining regulation, for example, onshore mineral resources.

Alternatively, legal harmonisation is an efficient and effective method of reducing regulatory burden. It enables the states to implement principles of regulating a particular area, for instance coal seam gas extraction, without having to refer their powers or implement mirror legislation that requires changing when one jurisdiction makes a change. Rather, legal harmonisation allows the principles of regulating that area of law to be imbued, leaving the details to the individual states, in a manner similar to EU directives.

Without implementing some changes, it is likely that the level of regulatory burden will continue to increase in the 21st Century. Without the political will to implement change, by the middle of the century, the regulatory setting in the Australian Federation may well be drowning in a sea of federalism.

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## 2.4

# Performance comparison in Australian federalism

Alan Fenna



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In April 2014, the Commonwealth announced its decision to abolish the COAG Reform Council (CRC) and transfer or scale back the CRC's responsibilities for monitoring the service delivery performance of Australia's state and territory governments. This closed a brief but promising chapter in Australian federalism and ended an experiment that had put Australia at the forefront of new developments in global federalism. The decision to terminate the CRC reflected, however, the challenging nature of such experiments. They require sustained commitment from all those involved and may be very slow in producing demonstrable benefits. In the absence of a return to a more classical division of powers and responsibilities in Australian federalism, though, there is little alternative to the kind of transparency the CRC provided.

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## Background

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When the Rudd Government came to office in November 2007, it did so with a promise to 'end the blame game' in Australian federalism. In particular, Rudd had promised to address the problems created by the very high degree of Commonwealth intervention in areas constitutionally the responsibility of the states. That intervention was overwhelmingly through specific purpose payments (SPPs), or 'tied grants'. These numbered close to a hundred, contributed a quarter of total state revenue and affected an extensive range of service delivery areas. Tied grants were widely seen as inefficient and sometimes ineffective, imposing a burden on the recipient jurisdictions and thoroughly obscuring accountability. They were – and are – made possible by the extremely high degree of vertical fiscal imbalance in Australian federalism.<sup>1</sup>

The Rudd Government promptly set to negotiating major reforms to these practices with the states as part of a turn to a much more genuinely 'cooperative federalism'.<sup>2</sup> By November 2008, the states had signed up to the *Intergovernmental Agreement on Federal Financial Relations*, which outlined sweeping reforms to the fiscal transfers system.<sup>3</sup> Those reforms were directed at fundamentally changing the grants system from one based on unilaterally imposed input controls to one based on consensually established outcomes targets. In exchange for the 'broad-banding' of sundry tied grants into a handful of block grants, the states agreed to a new accountability regime, one based on performance reporting and assessment.

The body charged with responsibility for that assessment already existed, at least in name. The CRC had been established in the later years of the Howard Government, but now it had a real purpose. Its job would be to evaluate the performance data and report to COAG on how well the various jurisdictions were doing in respect of the agreed-upon outcomes objectives. The primary source of those data already existed. This was the annual *Report on Government Services* (ROGS) produced by the Productivity Commission under supervision by an intergovernmental steering committee.<sup>4</sup> By this point, ROGS was into its 15th year, having been created during the intense reform period of the mid-1990s; however, its impact had never been great.

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## Reinvigorating federalism

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Although it has been a leader, Australia is certainly not alone in moving towards inter-governmental performance assessment or ‘benchmarking’. In a variety of ways, and to varying degrees, various federal or federal-type systems have turned to measurement as a way to navigate out of the rut they seem to be in. Performance measurement seems to offer ways to increase efficiency and accountability, in the process perhaps allowing federal systems to deliver on some of their putative advantages. The option of returning to some sort of golden age, when clear lines divided the powers and responsibilities of the two levels of government, can seem attractive.<sup>5</sup> But it is utopian — not only because of the great difficulty of constitutional change, but also because policy fields now rarely lend themselves to clear division. The status quo has elements of the worst of both worlds. Performance assessment regimes accept the reality of overlapping responsibilities but seek to rationalise the relationships involved.

Federalism is often said to provide important public policy benefits, notably competitive pressures and a multiplication of opportunities for policy experimentation and learning. Ideally, jurisdictions judge their performance against others and engage in a process of policy learning leading to the adoption of ‘best practice’. But the benefits of so-called ‘laboratory federalism’ are chronically undersupplied.<sup>6</sup> They require opportunity and incentive structures that are rarely present to an optimal degree. Among other things, jurisdictions must have a wide range of autonomy as well as effective mechanisms for policy learning; citizens, meanwhile, need a reliable and accessible way to judge how well their particular government is performing. Jurisdictions may need both prompting and assistance to encourage the dynamics of competition and learning. And for this, central governments may “need to assume both a learning role and a leadership role”.<sup>7</sup>

According to the private sector model from which the idea of benchmarking derives, individual jurisdictions (firms) are proactive in comparing with others and learning how to do things better.<sup>8</sup> Private sector businesses, however, have a direct and powerful incentive to engage in such practices: the profit motive. By their nature, public sector entities generally have no such incentive. Thus, in the public sector, benchmarking almost inevitably includes more of a ‘top-down’ element, with higher authorities imposing the requirement for performance assessment on subordinate units. In unitary or centrally dominated systems, this can take a decidedly coercive form. Such coerciveness sits poorly with the idea of federalism. However, the fact that the constituent units of a federal system are unlikely to subject themselves to comparative performance assessment spontaneously means that some central impetus will be essential. In a federal system, that central government role must strike a balance that stimulates action while ensuring willing cooperation. Central governments at the very least can play a powerful facilitative role in promoting and supporting benchmarking between their constituent units.

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## Caution required

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In theory, such a regime should help federalism shake off some of its torpor. But just as federalism in practice rarely lives up to the expectations of federalism in theory, benchmarking in practice faces considerable challenges. This is the case even for benchmarking carried out within a given jurisdiction, let alone between jurisdictions in a federal system.

The challenges are primarily those associated with the translation of a private sector device to a public sector environment. The nature of business is simple: In particular, the overriding goal is profitability in the sale of outputs. Those functions are readily measurable. By contrast, government is not primarily about outputs, it is about *outcomes*. “Output is never an end in itself for the public sector”.<sup>9</sup> It is not about how many classroom hours are delivered, operations carried out, or even kilometres of road laid. It is about things such as how the next generation is trained and socialised, the general health of the population, and the efficiency and suitability of the transport system.

These outcomes are often difficult both to measure and to influence. In seeking to measure governmental performance, inevitably one often has to settle for approximate or proxy indicators — measures that are, or can be, made available that stand in for the real objective. In turn, the reliance on such measures means the creation of perverse incentives. Driven by these incentives, behaviour is modified to match the measures, not the final objective (so-called ‘teaching to the test’). Even worse, ‘gaming’ occurs — particularly in ‘high stakes’ settings — as entities seek to generate performance data that tell the desired story rather than the real story. The difficulties involved in generating reliable data, directly comparable across jurisdictions, means that the development of effective benchmarking regimes is a highly iterative process that may take a substantial period of time that requires sensitive design.<sup>10</sup> Like many experiments in public policy, there is a substantial risk of “overpromising and underperforming”.<sup>11</sup>

The other key challenge of benchmarking in federal systems is to complete the chain of influence. Even the best performance-measurement system only provides information; somehow that information must feed into and influence the way jurisdictions do their jobs. Again, business firms are highly motivated to listen to and act on such information while public sector entities have much less intrinsic motivation – thus the need for an overarching regime with some kind of sanctioning effect. Hence the reluctance of public sector entities to engage in benchmarking.

Two forms of sanctioning prevail, and neither is particularly popular with those being assessed: financial rewards and penalties, and ‘naming and shaming’.

The former lodges power with the central authority, the latter with the public. Regimes that lean towards naming and shaming tend to publicise results in highly aggregated ‘league table’ form to make simple comparative evaluation easy. When applied energetically, neither is conducive either to honest reporting or to cooperative development of indicators and learning models.

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## A recent development in federal systems

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In the classical model of federalism there is little room for performance management regimes. The constituent units are ‘sovereign’ within their own areas of jurisdiction and directly accountable to their own constituents. Modern realities – particularly the tremendous amount of centralisation that has occurred – mean that the classical model is often little more than notional.<sup>12</sup> Intergovernmental benchmarking has emerged as one way of dealing with the complexities resulting from extensive *de facto* concurrency in federal systems. Just as federal systems differ greatly, though, so do these experiments in benchmarking.

At one extreme lie top-down programs such as the Congress’s *No Child Left Behind Act* (NCLB) in the United States. NCLB used Congress’s substantial power through tied grants to force the states to implement a performance reporting and management system in their education systems. It provoked fierce resistance from a number of states, had significant implementation difficulties and produced much-debated outcomes. More decentralised federations such as Canada and Switzerland have had very modest experiments with intergovernmental benchmarking. But further out at the decentralised extreme, the most celebrated – or, at least, certainly the most discussed – example of intergovernmental benchmarking is the European Union’s (EU) ‘Open Method of Coordination’ (OMC).

By contrast with the American example, the EU introduced its benchmarking regime precisely because it had no authority or leverage in the extensive range of policy domains to which the OMC was applied. It opted for a ‘soft law’ approach in which it had no ‘hard law’ capacity. Accordingly, the OMC is a highly collaborative process, which involves performance measurement but not sanctions and includes a qualitative dimension, ‘peer review’, intended to facilitate learning, understanding and dissemination of best practice. Precisely because the EU is too decentralised to be yet a fully fledged federation and have an overweening central government, its use of benchmarking has taken a form that could be regarded as best practice federalism and innovative ‘experimentalist governance’.<sup>15</sup> The main criticisms concern the limited nature of its results to date.<sup>16</sup>

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## The Australian experience

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The *Intergovernmental Agreement on Federal Financial Relations* addressed two of the main limitations on the states acting as learning organisations: giving jurisdictions more autonomy in how they exercised their functions, while establishing a regime exposing them to greater scrutiny in *how well* they exercised those functions. The autonomy came from the consolidation of a large number of tied grants into a small number of block grants as well as the Treasury-to-Treasury (rather than line agency) nature of the transaction. The scrutiny function likewise looked palatable to the states. The CRC was organised as a ‘joint venture’ body rather than a Commonwealth agency and it answered not to the Commonwealth but to COAG.<sup>17</sup> Furthermore, since the main block grants were no longer conditional, no funding was at risk from reported underperformance.<sup>18</sup>

From a ‘federalist’ or state perspective, however, the reform of the grants system was compromised in two regards.<sup>19</sup> One was a considerable pressure from within the Commonwealth Parliament and Government for lines of accountability to flow back through the Commonwealth, since that’s where the funds originated.<sup>20</sup> The other was that while the new SPPs cleaned the slate as far as the Commonwealth’s past misdeeds were concerned; they did not preclude fresh ones.<sup>21</sup> Indeed, the Agreement explicitly made provision for so-called National Partnership Payments (NPPs) — the old tied grants in a new guise. NPPs were conditional grants with funding dependent upon performance. The CRC was responsible for assessing whether states had performed as required. NPPs proliferated rapidly and it very much looked like the Commonwealth was “reverting to type”.<sup>22</sup>

The main problem with the CRC and the performance assessment regime was not that it betrayed the federal spirit, as the NPPs did, but rather that it failed to make a meaningful impact. This was acknowledged by the CRC itself. A major reason for this was the intrinsically challenging nature of the task, as previously mentioned. In the words of the CRC Chairman, “accountability for outcomes is not for the faint-hearted!”<sup>23</sup> The highly iterative nature of such exercises is clear from, if nothing else, the amount of time and effort the CRC required simply to establish baseline indicators. The other problem was – as sceptics would have quickly pointed out – in the absence of sanctions, what is going to compel compliance or responsiveness even once meaningful findings emerge? As the Council Chairman put it, “there is not a lot of evidence that governments are improving their performance in response to the findings”.<sup>24</sup>

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## Conclusion

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The CRC and the performance evaluation regime over which it presided was an acknowledgement that intergovernmental relations in Australia are inextricably entangled. This creates difficulties for a system that was originally envisaged as being based on the almost entirely separate and autonomous operation of the two levels of government. The CRC also represented an instance of the way that intergovernmental relations in Australia have been growing more formalised over the past 25 years.<sup>25</sup> At the same time, though, the summary abolition of the CRC demonstrated how tenuous that process of formalisation has been and how a substantial commitment to genuinely collaborative relations between the two levels of government does not change the underlying realities of Commonwealth dominance. There have been various calls for real institutionalisation of Commonwealth and state relations over the years and the CRC experience represents another illustration of the degree to which such developments would be welcome.<sup>26</sup>

A performance comparison and learning, or ‘benchmarking’, regime is not a panacea for what ails Australian federalism; however, there is no panacea. The situation in Australian federalism is a version of that envisaged in the economic ‘theory of the second best’. A classical dualistic division of powers may be the ‘best’ arrangement, but attempts to approximate that ideal are likely to result in outcomes that are far from the best; a second best alternative of a coordinated outcomes-focused performance regime could be the best real-world alternative. Benefits will be incremental and will require iterative and collaborative development and improvement; however, despite the demise of the CRC, something along those lines is the way to proceed.

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# SECTION 3.0

## Determining roles, responsibilities and functions

3.1 Criteria for assigning roles and responsibilities in the Federation

[Professor Kenneth Wiltshire](#)

3.2 Virtual local government

[Professor Percy Allan AM](#)

3.3 The need for strong metropolitan governance within the Federation

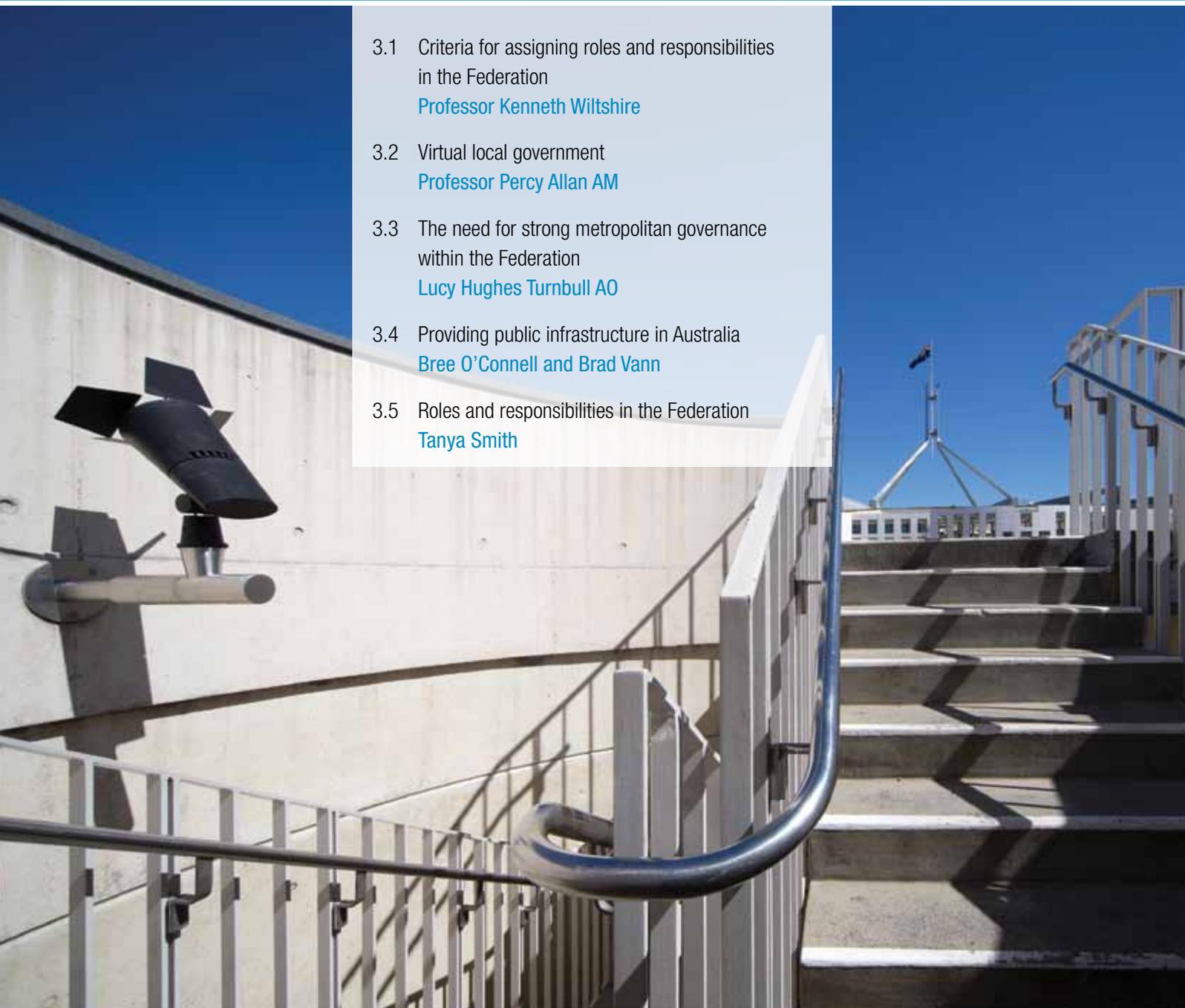
[Lucy Hughes Turnbull AO](#)

3.4 Providing public infrastructure in Australia

[Bree O'Connell and Brad Vann](#)

3.5 Roles and responsibilities in the Federation

[Tanya Smith](#)





## 3.1

# Criteria for assigning roles and responsibilities in the Federation

## Professor Kenneth Wiltshire AO



Professor Kenneth Wiltshire AO is the JD Story Professor of Public Administration at the University of Queensland Business School. He is the author of many books and articles on comparative federalism. Professor Wiltshire was for nine years a member of the

Commonwealth Grants Commission, served as consultant for the new federalisms of the Fraser and Hawke governments, was Chair of the Wet Tropics Management Authority, Chair of the Australian Heritage Commission, and Special Adviser to the Australian National Training Authority.

Professor Wiltshire served for six years as Australia's representative on the Executive Board of UNESCO, conducted the Review of the National Board of Education Employment and Training, and Chaired the Review of the Queensland School Curriculum. He is currently a joint panellist for the Review of the Australian School Curriculum.

In 1998, he was awarded the Order of Australia for services to policymaking, public administration and UNESCO.

When the American founders came to write the constitution for their new nation, they closely examined the successes and failures of democracies, both ancient and modern. They came to the conclusion that it was essential not to create any concentration of power within the system of government. So they sliced authority within the system in two ways:

1. Horizontally through the separation of powers between legislature, executive and judiciary; and
2. Vertically by means of a division of powers between national and state governments.

The approach to federalism was based on the assumption that there could be a neat assignment of separate revenue raising and expenditure functions to each of the two levels of government, making each level almost watertight and largely self-sufficient. Thus 'Layer Cake' federalism was born.

In doing this, the American founders were reflecting the dictum of Kenneth Wheare, the designer of many federations for former British colonies. His definition of federalism contains the words: "By the federal principle, I mean the method of dividing powers so that the general and regional governments are each, within a sphere, coordinate and independent".<sup>1</sup>

The word federalism is derived from the ancient word 'foedus', meaning a 'covenant' or 'compact' between sovereign states to create a nation with a division of powers between centre and region. The advantages of a federal system over a unitary one are considered to include diversity, responsiveness, encouragement of innovation and experimentation, and competition. A federal system also helps preserve national unity in culturally diverse societies.

The assignment of powers in federal constitutions is often also influenced by the societal context. For example, in multicultural and multilingual nations, the states retain powers relating to cultural aspects such as education, arts, broadcasting and communications, and occasionally the retention of different legal systems as well as concurrent powers over immigration. In developing countries like India, where land is a fundamental resource, states retain most powers relating to land use. Most federations list powers for one level and give residual powers to the others. Canada attempted to provide long lists for both national and provincial levels, and thus created a legal quagmire.

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## Layer cake federalism in Australia

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Australia's Founders were in pursuit of unity in diversity, and they largely followed the American recipe for their layer cake federalism, including the approach that the powers of the new Commonwealth Government would be listed and all residual powers would go to the states. There were just a few concurrent powers, a provision for some tax sharing, and it was assumed that Britain would handle most of Australia's external affairs powers.<sup>2</sup>

The first explicit emergence of criteria for allocation of powers arose at the key meeting of Premiers in Sydney in 1891. In a strategic move (which holds important lessons for today's public policy designers), Henry Parkes put forward a set of principles for discussion, realising that if agreement could be achieved on principles, the design of the Constitution and creation of the nation could begin.

Throughout the 1890s, some criteria were cited by the Founders as the successive drafts of the Constitution evolved. They were essentially that the Federal Parliament would have responsibility for areas that affected the whole nation, such as trade, immigration, postal and telegraphic services, marriage and divorce. The colonies, soon to become states, would also have to hand over their customs and excise taxing powers to the Federal Parliament, because a federation is a customs union with one external border. But a large share of these duties would be returned to the states as grants in recognition that the narrowness of their tax base would be inadequate for them to provide the functions they would assume. This was, of course, well before the arrival of income tax.

Sir John Quick, writing in 1919, recalled:

“In deciding upon the distribution of powers the Australian Federal Convention was guided not only by the model of the United States Constitution but by special considerations. It was thought that there should be reserved to the states all powers affecting private rights, municipal functions, local interests, resources that they should control; the administering of justice and local governing communities, and have a free opportunity for internal development and local option, and choice in internal affairs. To the Commonwealth were ceded such powers as of a truly national character, whether relating to commerce, industry, finance, economies, defence or external affairs. It would have been a great calamity had the Convention drawn up an instrument of government to last as the citadel of national life for all time merely in haphazard manner, without reference fundamental and guiding principles.”<sup>3</sup>

The colonies were somewhat apprehensive about surrendering powers to the new Commonwealth Government, but were finally assured that they would still have the upper hand because they had designed the Senate as a states’ house and it would have substantial leverage. And anyway, as Alfred Deakin said, “you cannot have an omelette without breaking eggs”.<sup>4</sup>

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## Kitchen rules

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It is well known that since 1901, the powers of the Commonwealth Government have grown exponentially in the Australian Federation. There are several causal factors for this, including:

- The emergence of a national economy rather than the six separate ones that existed at federation.
- The sheer growth of the public sector itself and the increasing complexity of the public sector with many functions interrelated.
- Globalisation and the centripetal forces that flowed into the Federation with powers accruing to the Commonwealth Government, especially external affairs and international treaties.
- Escalating vertical finance imbalance particularly through the takeover of income tax from the states during World War II and thereafter, which resulted in the Australian Federation having the greatest vertical fiscal imbalance of any federation in the democratic world.
- High Court interpretations that have, on balance, greatly increased the powers of the Commonwealth Government for various reasons, and allowed intrusion into a number of areas that had been the preserve of the states under the Constitution, including new arenas like the environment, which is still not mentioned in the

Australian Constitution. The High Court, of course, bases its decisions on legal interpretation. But it is of considerable relevance to this discussion of criteria that it has allowed some sections of the Australian Constitution to override others, for example, external affairs, and finance and company powers, to override other powers that were originally ceded to the states in the original Constitution. This is rare in the experience of federations; it certainly would almost never occur in relation to the Supreme Court of Canada.

- Some interchange of powers.
- The need for Commonwealth Government to intervene during national crises such as wars and depressions.
- Several referendums in which the Commonwealth Government gained new powers and revealed public reaction to new criteria for the allocation of powers in the Federation. There are three interesting cases:
  - The 1927 amendment giving the Commonwealth Government powers to control public borrowing was a response to reckless behaviour of the New South Wales (NSW) Government and the desire to stimulate economic growth;
  - The 1946 referendum giving power to the Commonwealth Government in welfare was a public response to the need to address challenges in post-war reconstruction; and
  - The 1978 referendum on indigenous affairs (the largest “yes” vote in Australian history at 90 per cent) was interpreted as public recognition that the states acting alone had not adequately addressed this arena.

All of these trends towards national government dominance also resulted in a complex layer of Executive Federalism cascading down from the Premiers Conferences, which are nowhere mentioned in the Australian Constitution, and which eventually morphed into the Council of Australian Governments (COAG), on through some 43 Ministerial Councils and around 350 intergovernmental agreements. Executive Federalism ‘got things done’ but at the very high price of a lack of accountability because of the substantial consequent swirling of levels of government in many areas of the public sector.

The wealthy chefs in Canberra were now doing all the baking and the layer cake became a ‘marble cake’. Overlap and duplication in the Australian Federation grew apace.

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## Recipes for marble cakes

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There were at least four major attempts in the 20th Century to address the issue of overlap and duplication, and to develop criteria to establish roles for each level of government:

1. The Kestnbaum Commission in the USA;<sup>5</sup>
2. The Rowell-Sirois Commission in Canada;<sup>6</sup>
3. The Australian Council on Intergovernmental Relations;<sup>7</sup> and
4. The rewrite of the German Constitution, the Basic Law, from 1949, which recognised the reality of changes in federal systems and endeavoured to assign roles and responsibilities to levels rather than just discrete functions.

Looking across all these attempts, a number of criteria become clear. They usually start from the premise that states are sovereign partners in a federation. So they are mainly to do with the circumstances when a national government should become involved in a public sector function that is designated as a state function in the constitution of a federal system.

It is noted that in many cases, these goals could be achieved by the states alone, acting in concert, through an interchange of powers, mutual recognition of legislation, or through concurrent or mirror legislation. These days technology also provides much scope for states to share resources and innovations with one another. However, as the American John Adams pointed out, it is difficult, if not impossible, to get so many clocks to strike at once. Also, the role of arbitrator will often be assigned to the national government when the state and territory jurisdictions cannot agree among themselves.

A national government presence may be required to achieve:

- Aspiration, patriotism or exhortation on a national goal or issue;
- Uniformity, particularly of national standards;
- Universality of coverage and access;
- Guaranteeing mobility and portability across the nation, which includes regulation of mobile resources and citizens;
- Providing equality of opportunity and accessibility including spatial equity;
- Filling identified gaps in service delivery (usually until the states pick up the initiative – this may require a sunset clause on national government intervention);
- Achieving economies of scale;
- Coping with spill overs between jurisdictions;
- Addressing asymmetry where small jurisdictions may not have resources to provide services comparable with that of others;
- Encouraging and funding research and innovation to benefit the whole nation;
- Meeting international obligations and achieving international competitiveness; and
- Guaranteeing national security.

In addition, a role emerges for a national government when ‘overrides’ become necessary in a federation, typically because of a crisis or emergency, for example, gun control, hyperinflation or severe economic recession, natural disasters and terrorism.

Justification for greater national government involvement also arises as a result of ‘linkages’, which see national government powers connected to those of states, for example, housing, welfare, immigration, education, health, crime and enforcement.

Of course, the involvement of the national government will also inevitably be related to its superior financial resources through larger taxation powers and access to borrowings. Then vital state and local government functions such as provision of infrastructure will depend on national government intervention of some kind.

A number of criteria have also been posited for state and local government functions, including:

- Local knowledge;
- Closeness to clients;
- Community engagement and mobilisation of resources;
- Responsiveness and flexibility;

- Speed of delivery and nimbleness; and
- Where experimentation or innovation is warranted, which might then provide lessons for other jurisdictions.

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## Enter new federalism

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There have been five major periods of ‘new federalism’ in Australian history, all of which have involved a reconsideration of the powers of the levels of government.

### Post-depression

Post-depression there was intense cooperation between national, state and local governments, and executive federalism was born with a range of ministerial and administrative councils established. The criteria were simple and were all aimed at creating employment and facilitating borrowing for infrastructure. In essence, they were crisis-style override criteria.

World War II resulted in intense cooperation between the national and state and territory governments, with the national government taking over many functions including income tax, and coordinating many others including transport, provisions and rationing.

### Whitlam Government

The Whitlam Government introduced new program areas for the Commonwealth Government, with a strong centralising initiative. The main emphasis was addressing what was seen as areas of neglect such as urban and regional development, environment and heritage, welfare and education. These areas were not strictly speaking national government powers, and indeed many of these functions were achieved by bypassing the Constitution. In effect, many of the programs sought to override the states on the grounds of national or even international interest.

### Fraser Government

The Fraser Government’s new federalism was aimed at rolling back national government intervention largely based on notions of states’ rights and reducing government intervention. The criteria mainly centred on reducing overlap and duplication, and ideological notions such as de-concentration of power. Significantly, there was an attempt at tax sharing with states and territories, and local governments, through having an allocated share of the income tax base and giving the states and territories the capacity to add or reduce their tax level. This never eventuated because of bogus claims of double taxation. The Fraser Government had also formally brought local government into the tent of intergovernmental discussion for the first time.

### Hawke Government and the 1990s

The most interesting period in relation to criteria was the Hawke Government’s new federalism. Having achieved a number of significant macroeconomic reforms, the Government turned to microeconomic reform and found that the states and territories controlled most of the levers in this domain. So, efforts were aimed at achieving

collaboration between national, state and territory, and local governments to address this national aim. A new model was born in that, instead of following past approaches to revise the allocation of whole functions of government, there was an acceptance that many functions would continue to be shared. The real challenge was to identify roles and responsibilities within the shared function. In doing this, the government was, in essence, following the German model. From now on 'national' would no longer automatically mean 'national government'; it would mean 'partnership'.

Most importantly, there were four principles underpinning this new federalism:

1. The nation principle, which recognised that Australia was one nation;
2. The subsidiarity principle, which recognised that a government function should be delivered by the government closest to the client;
3. The structural efficiency principle, which means that the structures of a federation should operate as efficiently as possible; and
4. The accountability principle, which identifies that the operation of the whole federal principle should be accountable to the people.<sup>8</sup>

Another significant modality that would be employed was mutual recognition by each state and territory of some of the other jurisdictions' laws.

And so the significant reforms of the 1990s began, including National Competition Policy, a national electricity grid, nationally consistent food labelling and national rail freight coordination.

Having addressed responsibility sharing on the expenditure side, Hawke considered an attempt at tax sharing, but this fell afoul of the Keating challenge to Hawke for the Prime Ministership; since Keating, trained at the knee of Jack Lang, was a centralist and not a federalist.

The Howard Government turned Australian politics on its head when it became centralist in policymaking. Part of this trend can be accounted for by the fact that almost all of the states and territories were then Labor governed. Whatever the cause, it meant that all the major Australian political parties were now centralist for the first time in the nation's history.

### Rudd Government

Enter the Rudd Government's new federalism, which was characterised by a promise to reduce the overlap and duplication in the Federation. This was primarily by reducing over 100 individual specific purpose programs to six major block grants, all of which would operate by way of partnership agreements setting out desired outcomes and defining roles and responsibilities. However, all these agreements were eventually subject to a national government financial control or veto. There was also the threat of a national government takeover of some powers such as hospitals lurking in the background. The COAG Reform Council would oversee performance of the system and it had been very critical of the performance of these arrangements until it was recently abolished.<sup>9</sup>

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## The false dichotomy

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In contemporary Australia, whenever public policy for the Federation is discussed, a false dichotomy is often instantly propagated: The Commonwealth Government is about policy and the states are about service delivery.

This is fundamentally false because in a true federation, the states are sovereign and therefore must be policy partners in any intergovernmental negotiations and not merely service deliverers. A partnership is not a partnership unless the partners are equal. This is overlooked so often because of the chronic vertical fiscal imbalance in the Australian Federation in which the Commonwealth Government, by default, raises over 70 per cent of all public revenue, and therefore comes to see itself as the policymaker.

It is also false because public policy is a spectrum and must include policy design right through to implementation. And, at any event, in any system the service provider is usually in the best position to shape the policy design.

The other 'elephant in the room' is always the view propagated, particularly by the business sector as a key component of its views about overlap and duplication, that the states should be abolished and Australia should become a unitary system. Of course the Labor Party has also long held, as part of its platform, that the states and the Senate should be abolished. All of this tends to diminish the importance of the states in the eyes of the community, and offers a simplistic solution to the challenge of developing criteria for the allocation of roles and responsibilities in the Federation.

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## Governance: The icing on the cake

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In Australia, any attempt to identify the ingredients that caused the swirls in the marble cake will fall foul of the thick layer of icing covering the governance arrangements. We have experimented with a vast array of governance designs for intergovernmental bodies such as the Murray-Darling Authority, Great Barrier Reef Marine Park Authority, Snowy Mountains Authority and Australian National Training Authority. Most have been statutory authorities established under Commonwealth legislation. Some have required mirror legislation in all participating jurisdictions. Some have been in a company format while others have rested just on an agreement or memorandum of understanding.<sup>10</sup> None have been free of potential political interference, and all have been very low on public accountability. The Minutes of Ministerial Councils are not made public and neither are those of the intergovernmental management bodies in most cases. Intergovernmental relations is exempt from Freedom of Information laws.

From a long period of experience, it would seem that a company format for intergovernmental management bodies is the best model for the future. It would achieve buy-in from all jurisdictions, prevent expert board members from acting as representatives and make their prime loyalty to the mandate of the body, and create transparency and arms-length decision making from politicians. Most importantly, it would reveal the criteria used to allocate roles and responsibilities in the functional area. With minutes made public and containing full reasons for all decisions, the public and Parliament and its accountability watchdogs would be able to sheet home responsibility for performance and impact on citizens.

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## The case of education

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In virtually all federations, school education is a state government power, being one of the most powerful symbols of state government sovereignty and difference.

Higher education is something of a special case and is often a shared power between national and state governments. The justification for involvement of the national government in higher education revolves around several factors:

- **Research:** Universities have research as a prime focus, and research, as a public good, benefits the whole nation. It is also costly and is often beyond the means of many state and territory governments.
- **Spill overs and mobility:** There is considerable interstate migration of students for their university education. Similar arguments apply in respect of equal opportunity to enter higher education nationwide.
- **International relations,** including honouring of treaties, monitoring and regulation of standards for international students, and coping with visas and related aspects.

School education is usually a jealously guarded power of state governments, related to local, cultural and sheer sovereignty claims by regions. Consequently, any debate about criteria revolves around the justification for national government intrusion into this space. The following points have been the main criteria in Australia and elsewhere:

- **Process roles,** including leader, coordinator, facilitator, catalyst, enabler, aspirational encourager and champion of patriotism and social cohesion, and promoter of innovation;
- **Funder,** especially where, as in Australia, the national government possesses much superior revenue sources;
- **International roles,** including research benchmarking; monitoring competitiveness; and diplomatic and functional relations with international education bodies such as the Organisation for Economic Co-operation and Development (OECD), UNESCO, Asia-Pacific Economic Cooperation (APEC), and the European Union (EU); as well as bilateral relations with many countries and regulation of national standards and accreditation of international providers;
- **Coping with linkages of education with other functions** such as immigration, welfare, health, social policy and higher education including teacher education;
- **Identifying gaps,** for example, it is doubtful if the 'Closing the Gap' program to address indigenous disadvantage would have occurred without a national government presence and stimulus (however another principle could be that all such initiatives should have a sunset clause so that a review can take place every five years to evaluate whether a national government presence is still warranted);
- **National standards for teaching, curriculum, and reporting and accountability;** and
- **Facilitating mobility of students and teachers across the nation,** through uniformity, portability, accessibility and universality of entitlement.

The challenge in relation to school education can be seen starkly by considering the world's top performing countries in international tests as identified by the OECD. Top performing countries take a holistic approach to education comprising the following elements:

- A focus on the wellbeing of students and their individual progress;
- A sound curriculum based on a clear set of values, principles and educational aims;
- High-quality teachers who are motivated and appreciated;
- Leadership from school principals;
- Resourcing;
- Parental and community support, accountability, reporting and quality assurance linked to systemic school improvement; and
- The conceptualisation capacity of the students.

Looking at these components, it is clear that Australia faces a significant challenge in taking such a holistic national approach, largely because of the way responsibility for each component is allocated to different levels of government. Also, both levels of government are involved in the very confusing funding of schools for both government and non-government sectors. States and territories are mainly responsible for teachers but the Commonwealth Government can influence teacher pre-service through its responsibility for university funding, and so on. Therefore, it requires a major effort to achieve consensus on each element for this ideal of a holistic approach, which simply does not exist in Australia.

The diversity in schooling across Australia is quite staggering in very many respects. This includes length of school day and year, streaming, internal and external assessment, and phasing of progression of students. A few states and territories have syllabuses but most don't. It is even doubtful whether school attendance is actually compulsory in all states and territories. The borderline between school, vocational education, and university is also now blurred. Some TAFE colleges and private providers offer university courses; 25 Australian universities and many vocational education providers now offer so-called 'bridging' courses for tertiary entrance, which are mostly remedial courses in literacy and numeracy. The reasons for all these differences are often lost in antiquity or not apparent.

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## School curriculum: The 'what' and the 'how'

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School curriculum is a particularly interesting case since Australia is now the only federation in the world with a reasonably comprehensive national school curriculum. Germany and America have national standards, and America also has some rudimentary content under the Obama Government's program, although not all states participate.

In many countries, the drive for a national curriculum has come from the increasing significance and impact of international tests such as Program for International Student Assessment (PISA), Trends in International Mathematics and Science Study (TIMSS) and Progress in International Reading Literacy Study (PIRLS), which have created de facto international league tables for countries in educational performance. Australia has lagged badly in several aspects of these tests and people look to the Commonwealth Government to coordinate action to address this concern.

Prior to the national curriculum in Australia, there was a significant variety of approaches in the states and territories; some did not have formal curriculums. NSW and Victoria had fairly robust systems and so were more reluctant starters.

Benefits of having a national school curriculum include:

- Introducing an actual curriculum in many states and territories where previously there was none;
- Coordinating efforts to address shortcomings revealed in international tests;
- Lifting aspirations for all levels of achievement;
- Introducing national standards and benchmarks;
- Facilitating mobility of students and teachers;
- Uniforming rigour that may have been previously uneven across the nation;
- Enabling greater access to teaching resources;
- Benefiting smaller jurisdictions that are without the scale to design and update curriculum; and
- Creating nationwide equity and entitlement.

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## Sovereignty over delivery: What versus how

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Despite the welcome that states and territories have extended to national government involvement in some aspects of national curriculum, there is fierce territorial control exerted by the states and territories over the delivery of the curriculum for primary and lower secondary levels. Also, possession is still 10 points of the law when any aspect of upper secondary schooling is considered. Here the states and territories jealousy guard all their rights in this domain, including protecting the fiefdoms of their number-crunching assessment authorities responsible for exit-level Year 12 testing leading to tertiary entrance.

The simplistic criterion advanced by the states and territories in relation to school curriculum is that the Commonwealth Government is about the 'what' but the states are about the 'how'. As an extreme example, at present, the national curriculum authority, Australian Curriculum, Assessment and Reporting Authority (ACARA), is forbidden by the states from directly contacting schools.

The states and territories also control the certification of schools and, despite evidence that this is often a very flawed process in some jurisdictions, the Commonwealth Government is not welcome in this domain either. All this leads to considerable doubts about whether the national curriculum is actually being implemented as intended across the nation. Indeed, many jurisdictions are adapting and adopting as they see fit and do not have rigorous quality assurance processes in place.

A national curriculum that is not being implemented is not a true national curriculum. It is also a national disgrace that parents are allowed so easily to opt out their children from the National Assessment Program – Literacy and Numeracy (NAPLAN) testing, since a national curriculum without assessment of all students is not a true curriculum and cannot monitor progress of all students, establish equity of entitlement across the nation, or assist teachers with diagnostic instruments. The laxity of some jurisdictions on this aspect is cause for considerable concern. The Commonwealth Government seems content to hand over millions of dollars to jurisdictions and sectors on condition of implementing the national curriculum without any checks as to whether these commitments are honoured. Some states and territories are just as slack in monitoring

schools during their certification process to be sure the national curriculum is being implemented.

There is also a strange and curious picture regarding the governance of the national curriculum process. A Ministerial Council issues instruction to ACARA, and the Board members of ACARA are appointed on the recommendation of the national and state ministers. The states and territories in reality have the majority of votes on both the Ministerial Council and the Board of ACARA, and they provide half of the funding for ACARA. However, they still see ACARA as a national government body. This makes little sense and can only be because the formal statutory location of ACARA is under national government legislation. This returns us to the governance question in inter-governmental relations discussed earlier.

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## Lessons

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Looking back over the many attempts to identify criteria for assigning roles and responsibilities in the Australian Federation, two points stand out:

1. A pure layer cake is no longer possible – it is not feasible to reassign complete functions of government to particular levels; and
2. Marble cakes are the menu of the day, so it becomes a matter of assigning roles and responsibilities within shared functions of government. This applies to both revenue and expenditure.

It is a false premise to assume that the Commonwealth Government will always have the key policymaking role, and the subnational levels the delivery role. In a federation, the states and territories are policy partners, not just service deliverers.

Any attempt to clarify the roles must begin with revenue sharing. Until the partners are on an equal financial footing, there is no point trying to assign expenditure roles. In Australia, this means that the states and territories and local governments are going to have to be given or take back added taxation powers, preferably income tax sharing as was intended by the Founders of the Constitution.

Many criteria exist to facilitate the unravelling of the overlap and duplication. They need to be applied from a basic assumption that justification is required for the Commonwealth Government to become involved. It must be recognised that many of these criteria, which have been outlined, are not mutually exclusive and some trade-off, ranking, or compromise will be required among them. It is also worth considering that any assigned role for the Commonwealth Government should have a sunset clause attached, for review after five years, to see whether the national government role is still required.

Where it is determined there should be joint responsibility for a function, the actual role of each level must be identified to ensure direct accountability to citizens. Accountability should also be more vigorously taken up by regimes such as auditors and ombudsman at both national and state level, as well as to parliaments, which should oversee all such intergovernmental activity. A special Senate committee on intergovernmental relations should be established to perform this function constantly.

Governance arrangements for intergovernmental bodies need to be designed to achieve buy-in from all levels of government but also maximum accountability and independence, so that they can function on expert evidence and not merely political or policy considerations. The criteria they apply in decision making must be transparent

and their minutes should be made public with reasons for all decisions clearly stated. A corporate model would be best to achieve all these objectives. Any directions from ministerial councils must also be fully and publicly documented. Above all, they need to be made far more accountable to the public for their decision making.

Almost all adult Australians carry two cards in their pocket or purse – a Medicare card and a drivers' licence – and they probably never bother to ponder why one is issued by the Commonwealth Government and the other by the state or territory government. We also know from past surveys and press reports that, when things go well, most Australians probably do not really care which level of government delivers a service as long as it is delivered efficiently and responsibly. But when things go wrong they need to know who is accountable and they do not appreciate buck-passing.

Perhaps the single measure that would best shake up this whole area would be a requirement that the plaque on every school hall and hospital should contain the names of the national, state or territory minister. Then people would know who designed the recipe and baked the marble cake, and pass informed judgement as to whether it is to their taste.

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#### Endnotes

- 1 Wheare, KC 1963, *Federal Government*, Oxford University Press, p.10.
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- 7 Grewal, BS; Wiltshire, K; and Balmer, C 1981, *Towards Adaptive Federalism*, Canberra, Australian Government Publishing Service; Economic Planning Advisory Council 1990, *Towards a More Cooperative Federalism*, Discussion Paper 90/04, Canberra.
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- 9 McClintock, P 2013, 'COAG's Reform Agenda', *Australian Journal of Public Administration*, 72(1), pp. 66–72.
- 10 Wiltshire, KW 1986, *Planning and Federalism*, St. Lucia, UQ Press; Wiltshire, KW 1980, 'Working with Intergovernmental Agreements – the Canadian and Australian Experience', *Canadian Public Administration*, 23(2), Fall, pp. 353–379.



## 3.2

# Virtual local government

## Professor Percy Allan AM

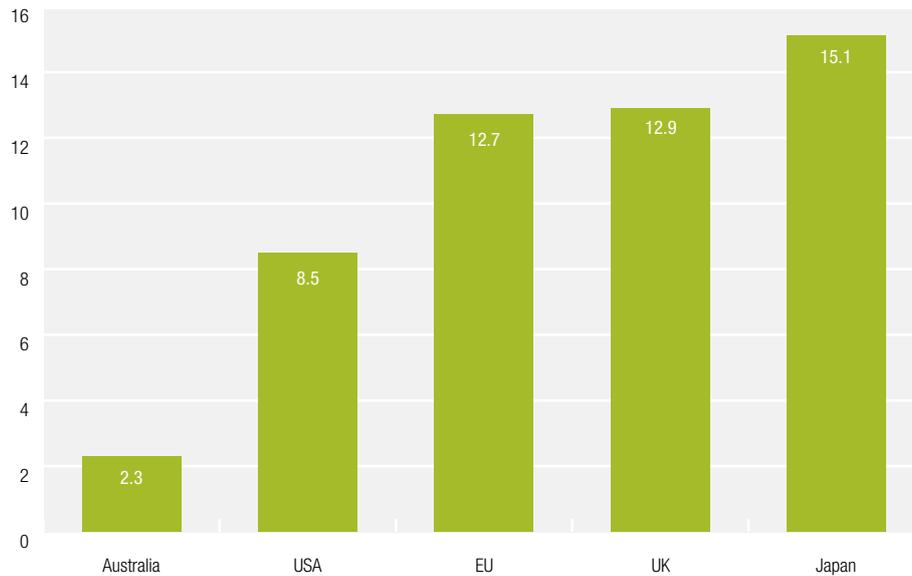


Professor Percy Allan AM advises on public policy, management and finance. He is a former Secretary of the NSW Treasury (1985–94) where he reformed the State's budgetary, accounting and financial reporting systems, corporatised its government enterprises and conceived the Independent Pricing and Regulatory Tribunal. He was then Finance Director of the Boral Group (1994–96) where he overhauled its financial management systems. He subsequently chaired the NSW Premier's Council on the Cost & Quality of Government (1999–2007), a racing regulatory body (2003–12) and an equity funds manager (1999–2012). Professor Allan was National President of the Institute of Public Administration Australia (IPAA) from 2010–12. He currently chairs a sporting complex trust and a share market advisory practice. He has been a Visiting Professor at MGSM, one of Australia's leading business schools, since 1996. He currently chairs a sporting complex trust, a share market advisory practice and a state government mining assessment committee.

Our local government sector is small by world standards, accounting for only around six per cent of general government outlays and three to four per cent of total taxes collected in Australia.<sup>1</sup> Local government expenditure as a proportion of gross domestic product (GDP) is only 2.3 per cent in Australia compared with eight to 15 per cent in other developed countries (refer to Figure 1).<sup>2</sup>

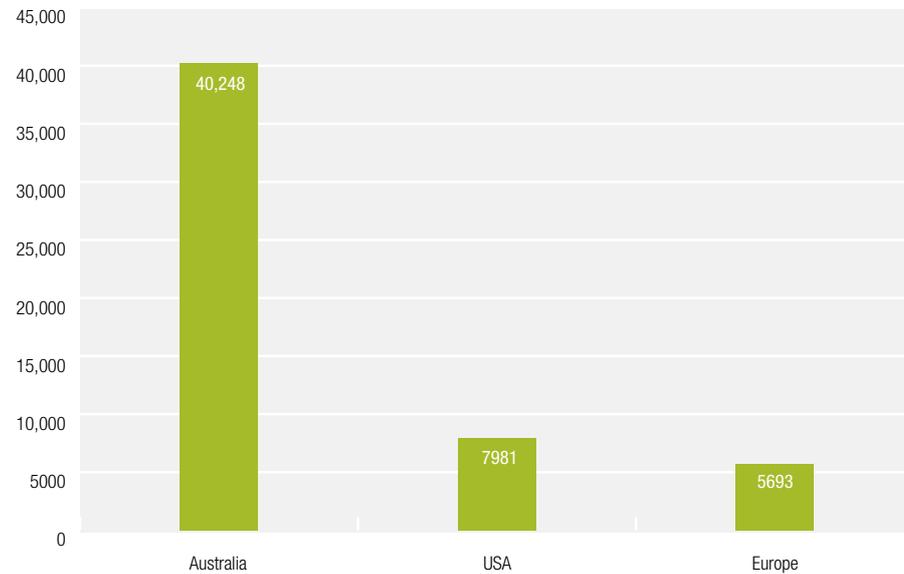
Yet paradoxically, Australia's local councils are big by world standards. In 2011, the average residency size of local government units in Australia was more than 40,000 residents; in the United States (US), 7981; and in the European Union (EU), 5693 (refer to Figure 2).

**FIGURE 1**  
LOCAL GOVERNMENT EXPENDITURE AS A PERCENTAGE OF GDP (2006)



Source: Dexia Bank

**FIGURE 2**  
AVERAGE SIZE OF LOCAL GOVERNMENT BODIES BY POPULATION (2011)



Source: Dexia Bank

## The merger myth

One of the main arguments advanced for merging councils is that increased size would increase cost efficiency. As MA Jones states, “It was once thought that small local governments allowed more community control but were more costly than larger units”.<sup>3</sup>

Yet, researchers both here and abroad have found that larger councils do not exhibit lower unit costs of servicing than smaller ones.<sup>4</sup>

It has been found that some council functions are done best on a large scale while other tasks are performed better on a small scale. “Smaller units are the most democratic and participative, and also the most efficient.”<sup>5</sup>

In fact, the 2006 New South Wales (NSW) Local Government Inquiry<sup>6</sup> “found no conclusive evidence that mergers would reduce unit costs. For smaller rural councils a lack of population density rather than size appeared to be the main cause of higher operating costs per resident”.

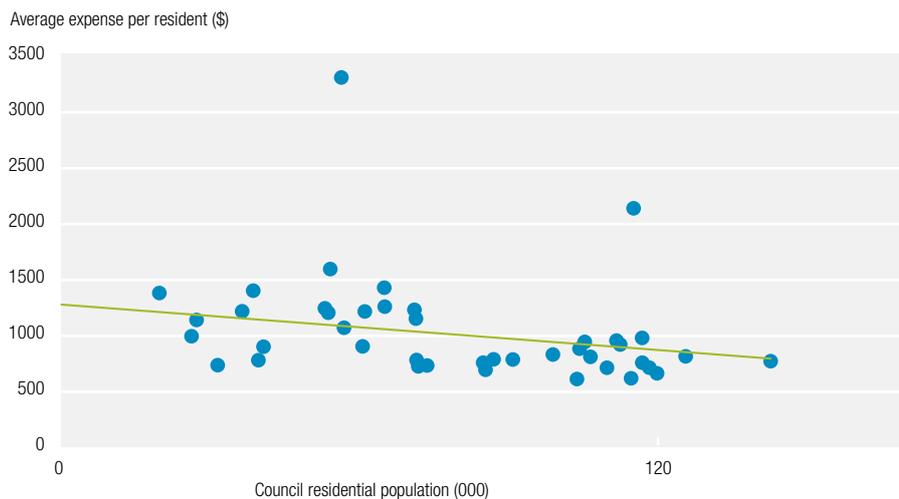
“Increasing population yields a lower level of gross expenditure per capita, however, once this reaches a point between 31,500 and 100,000, increasing population size results in higher levels of gross expenditure per capita.”<sup>7</sup>

“Concentrated structures were associated with higher spending than more fragmented local government and that there may be diseconomy of scale factors operating that outweigh the technical benefits of larger units.”<sup>8</sup>

As a case in point, Sydney metropolitan councils show no significant economies of scale, that is, average council cost per resident has little bearing to council size.

**FIGURE 3**  
COUNCIL PER CAPITA EXPENSE VS POPULATION SIZE (2010-11)

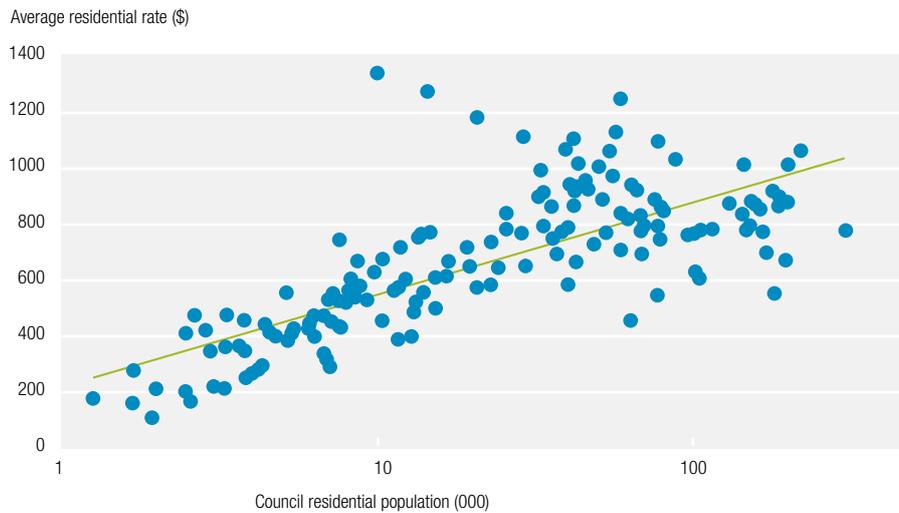
### NSW metropolitan councils



Source: DLG, Comparative Information on NSW Council, 2010-11

**FIGURE 4**  
**COUNCIL AVERAGE RATES VS POPULATION SIZE (2010–11)**

All NSW councils



Source: DLG, Comparative Information on NSW Council, 2010–11

Furthermore, larger councils in NSW generally charge higher rates than smaller to medium-size councils charge.

The ‘big is better’ argument is not always apt for a public bureaucracy where being nimble, flexible and cost conscious can be difficult given the bigger the span of control. For instance, in 1965, Australia Post moved all Sydney’s mail sorting to one building, the Redfern Mail Exchange. Instead of achieving economies of scale, the result was a demoralised workforce, union dargs and lower productivity.<sup>9</sup> Australia Post was forced to restore decentralised mail sorting and to focus on the real problem – getting the workflow processes right.

The reality of council operations is that some services enjoy economies of scale while others suffer diseconomies from aggregation. A one-size-fits-all approach is both crude and dangerous. As Brian Dollery notes, “the results of amalgamations (in Australia) has not met expectations ... structural change through compulsory council consolidation have not been effective in achieving their intended aims of meaningful cost savings and increased operational efficiency.”

Mergers are unlikely to yield efficiency gains where legislation (such as that in NSW) prohibits:

- Merged councils from having forced redundancies for three years;
- Changing employees’ terms and conditions;
- Relocating staff outside the boundaries of the former council area if they claim hardship; and
- Reducing pre-existing employment levels in rural areas.

Where small scale is a handicap, it can be overcome (especially in metropolitan areas) by creating ‘virtual’ councils that use a shared services centre or outsource their functions, for example, rate collections and capital works, to specialist providers.

**FIGURE 5**  
**SHOULD OUR COUNCILS BE BIGGER?**

Local council processes		
Process	Example	Scale efficiency
Routine processing	Rate notices, paying invoices	✓
Case-by-case determinations	LEPs, new traffic signs	✗
Capital works and maintenance	Footpaths, lawn mowing	✓
Corporate services	Policies, codes, community consultation	✓ and ✗

Source: Review Today <reviewtoday.com.au>

For instance, today more than a quarter of California's cities (about 130) are contract cities based on the 'Lakewood model':

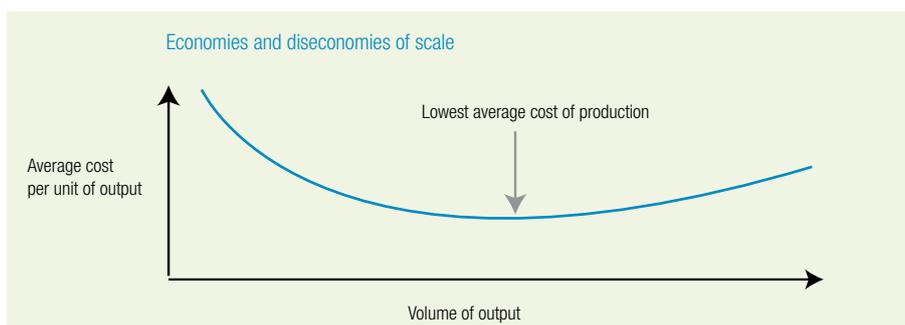
"Lakewood of the early 1950s was David fighting the Goliath of Long Beach, a city intent on gobbling up its unincorporated neighbour parcel by parcel. The legal turf battles were exhausting Lakewood's defenders, most of whom were transplants drawn to the promise of this sleepy village-turned-post-war boomtown. Then along came John Sanford Todd, a struggling attorney and proud Lakewood resident, who dreamed up a way to preserve his community's independence without it going broke: It would become a new kind of city, one that contracted out for police protection, trash collection, firefighting – just about every service a city provides.

"That practice is commonplace in the USA today, but it was a revelation a half century ago. Todd's vision, dubbed 'the Lakewood Plan,' became a model of local government that informed incorporation drives throughout Southern California and beyond. Suburbia took shape in a rash of 'contract cities,' including the neighbouring Dairy Valley (now Cerritos), La Puente, Bellflower, Duarte, Irwindale, Norwalk and Santa Fe Springs, which sprang up in such rapid succession that some observers began proclaiming the end of big cities."<sup>10</sup>

## Post-industrial efficiency requires speed not scale

The argument in favour of larger councils is based on the theory of economies of scale first proposed by Ronald Coase in 1937 to explain the efficiency of large corporations using assembly lines. "Large organisations, such as companies, make sense when the 'transaction cost' associated with buying things on the market exceed the fixed costs of establishing and maintaining a bureaucracy."<sup>11</sup>

**FIGURE 6**  
**EFFICIENCY AND SIZE – THEORY**



However, Coase also recognised that there were limits to scale efficiencies, beyond which, unit costs rose with each extra output. Initially, cost efficiencies were obtained from division of labour and specialisation of tasks, increased scope for shared services and increased dimensional capacity. Beyond a certain point, unit costs rose from control span limits, coordination complexity, and communication and information network requirements.

But a lot has happened to organisations since Henry Ford pioneered mechanising production on a large scale using assembly lines. A 2001 Special Supplement in *The Economist* declared, “Modern technology is shifting the balance of advantage away from firms and towards markets. The current goal is to focus on the few things at which they undoubtedly excel and to hand over everything else to equally focused specialists”.<sup>12</sup> This is something that Lakewood County and its successors found.

Aggregating activities together in a large organisation does not necessarily ensure economies of scale let alone service effectiveness. Take for instance anti-dumping laws designed to protect local producers from subsidised imports sold below cost. They are administered by a branch within the Australian Customs and Border Protection Service. In 2012, an inquiry (chaired by former Victorian Premier, the Hon. John Brumby) was established into whether the function should be performed by a separate standalone anti-dumping agency following evidence that the existing complaints process is too slow and cumbersome.<sup>13</sup>

What matters in both business and government now is not size, but speed. Speed is obtained through greater flexibility using a Shamrock-style structure as advocated by Charles Handy<sup>14</sup>, not a giant bureaucracy as preached by Coase. Shamrock organisations concentrate on their core role and outsource everything else. Their organisational structure consists of three parts:

1. Core staff, for example, senior management and others who do what can't be easily outsourced;
2. Contractors, for example, individuals who once worked for the organisation but now supply generic services to it; and
3. Consultants, who are professional and hi-tech workers who provide customised services to the organisation.

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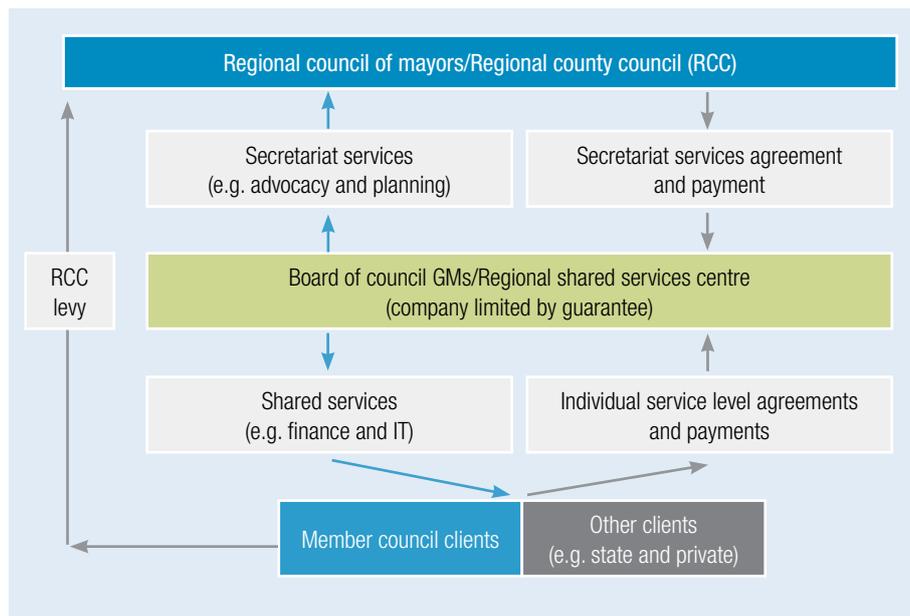
## Redesigning councils to become virtual

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Virtual councils address both the popular demand for small discrete municipalities that are close enough to residents to address their special needs, and the administrative advantage of doing some things on a large scale to achieve cost efficiencies, standardised outputs and the option to switch supplier if service delivery is not satisfactory. That's the nub of the challenge facing local governance.

Lakewood-style councils use a shamrock organisation structure to achieve such an outcome. They employ a small full-time professional staff who outsource generic tasks and use part-time contractors for specialist work. Australia's local governments should be encouraged by state governments to adopt such a model. It could be trialled in one region with the state offering its local councils infrastructure rehabilitation grants in return for their active cooperation.

**FIGURE 7**  
**A REGIONAL LOCAL GOVERNANCE STRUCTURE**



The first step would be to merge administrative functions of neighbouring councils that would benefit from economies of scale and scope (as established by an expert inquiry) into a linked shared services centre (SSC) that would be run as a commercial cooperative by member councils.

A public company or cooperative structure is best suited for operating a SSC because it is more operationally flexible and economically competitive than a county council structure.

Commercial contestability is important, not only for retaining council membership, but also for expanding sales to other clients in the public and private sectors.

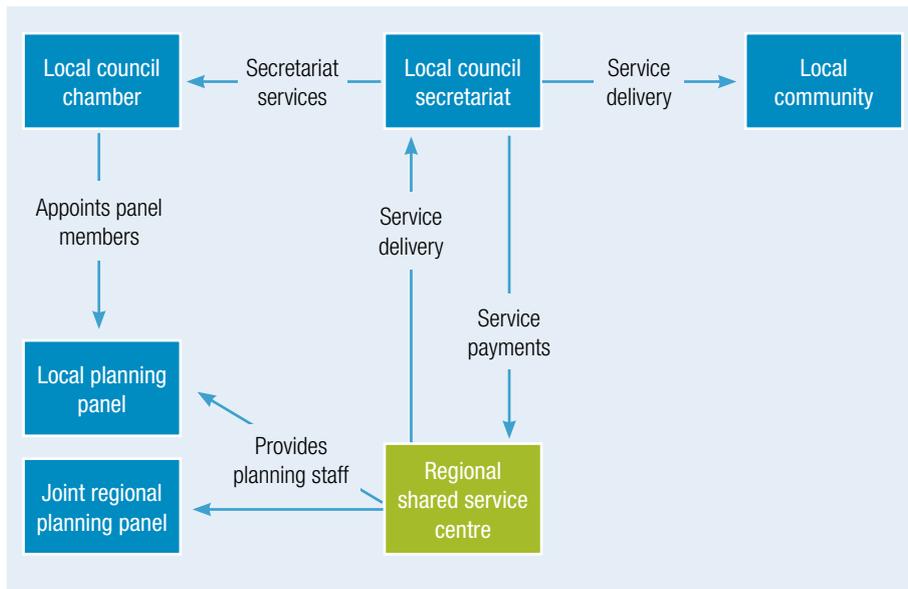
However, a county council model is better suited for regional planning functions for which regulatory powers are required. The county council model, by giving an existing regional organisation of councils (ROC) a statutory basis, would also give it greater authority when making submissions to state and federal government agencies. The regional county council would consist of mayors of member councils (refer to Figure 7).

The SSC, as a public company, would have its own CEO and be governed by a board of directors consisting of general managers of its member councils. The SSC, besides serving member councils, would also serve a regional council of mayors presiding over a regional county council (that could take on regional planning and advocacy functions). As a cooperative, the SSC would pay an annual dividend to each member council commensurate with the value of services sold to it (refer to Figure 7).

Each council would retain a general manager with a small support staff to provide it with secretariat services including strategic planning and policy advice, to place manage the municipality and ensure the services centre fulfilled its contractual obligations. Each council, with the assistance of its general manager, would negotiate a services contract with the CEO of the SSC.

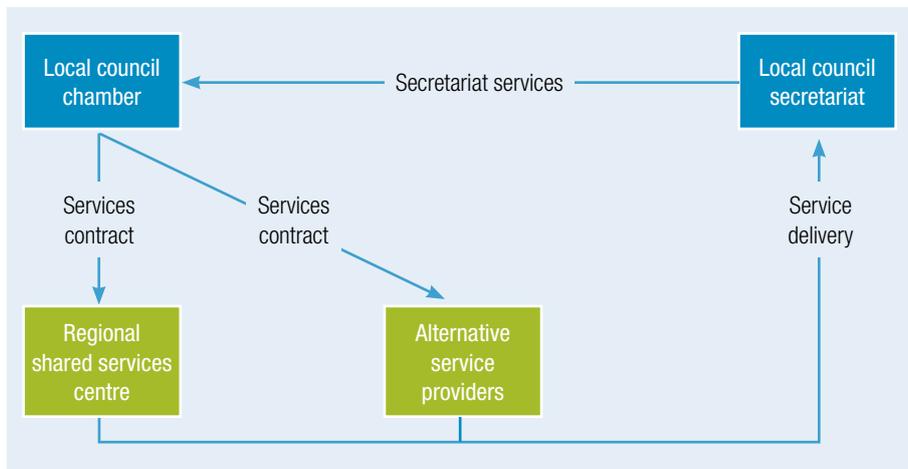
Each council would appoint an independent local planning panel (LPP) to decide all local development applications in accordance with council planning and development

**FIGURE 8**  
**LOCAL COUNCIL SETS LOCAL PLANNING POLICIES AND APPOINTS MEMBERS TO LOCAL AND REGIONAL PLANNING PANELS**



Source: Percy Allan & Associates

**FIGURE 9**  
**AFTER FIVE YEARS, LOCAL COUNCIL IS FREE TO NEGOTIATE SERVICE CONTRACTS WITH ALTERNATIVE SERVICE PROVIDERS**



Source: Percy Allan & Associates

policies. All councils within a region would continue to have a say in appointing a joint regional planning panel (JRPP) that decides development applications of a regional nature (refer to Figure 8). The SSC would have an ongoing mandate to provide professional staff to assist the local and regional planning panels with fees charged for providing such planning expertise set by the states' independent pricing authority, such as the Independent Pricing and Regulatory Tribunal in NSW.

After say five years, each council would be given the discretion to buy services from any provider, public, not-for-profit or private (refer to Figure 9). Shifting business to alternative providers would mean forfeiting cooperative dividends. Nevertheless, such a sunset clause would put the SSC on notice that unless it performed efficiently and effectively it could expect to lose custom once its five-year exclusive contract expired.

If a community wanted a smaller council for better place management of its services and infrastructure, such a contract model would allow municipal councils to splinter along precinct lines without sacrificing economies of scale and scope.

Indeed, a community contract council would bear some resemblance to a strata and community title owners' corporation that used a body corporate service secretariat to plan and engage its services from external providers, such as a shared services centre (jointly owned with other body corporates) and/or a variety of other specialist services providers serving multiple clients.

The main difference with the body corporate analogy would be that:

- The council chamber would remain a political body required to service the social, environmental and economic needs of the wider community rather than just focus on property management;
- The council's secretariat would remain a public service organisation accountable to elected councillors; and
- The SSC would be a commercial cooperative using activity-based costing to price its services and (except for planning panels) subject to market contestability after five years.

Critical to establishing community contract councils is the concept of an SSC. Following are examples of such centres used in not-for-profit organisations, private enterprise and state government:

#### Credit union movement

Independent shop fronts offer sophisticated financial services because they are linked to an SSC that acts as their bank, raise their finance, process their mortgages, service their ATMs, and so on. For example, CO-OP Financial Services, the largest credit union owned interbank network in the US, provides an ATM network and shared branching services to credit unions. In Australia, Cuscal Limited does the same.

#### American union movement

Small local unions with only a few hundred members offer full services because behind each is an SSC that provides them with membership processing, collection of dues, specialist legal advice for employee contract negotiations, newsletter production, discount deals, and so on.

#### Large corporations

Conglomerates such as General Electrics often pool their support services (for example, recruitment and training, payroll and leave processing, bulk purchasing, environmental and legal advice, and financial transaction processing) to free up their autonomous business units to concentrate on their core operations.

#### Business rivals

Vipro, jointly owned by the Commonwealth Bank, National Australia Bank and Westpac, was formed in 2005 to jointly process cheques on behalf of its owners. The consortium outsourced its operations to financial information services company Fiserv Inc., in a \$600-million, 12-year deal. It claims this shared service arrangement reduced costs, improved fraud prevention and saved capital investment associated with cheque processing.

### NSW Government

Currently, there are three shared service operators in the NSW Government: Service First, BusinessLink and Health Support Services. There are moves afoot to put their functions to tender to achieve competitive pricing and greater flexibility of operations.

According to the NSW Department of Premier and Cabinet,<sup>15</sup> a 2009 review of 193 public and private SSCs in the US, EU and Asia Pacific by the Hackett Group Shared Services Performance Study found that:

- Shared service reform delivers over 20 per cent reduction in cost with improved levels of service and quality;
- 71 per cent of shared services operations plan to achieve over 20 per cent reduction in costs; and
- 61 per cent of shared services operations have achieved over 20 per cent in savings.

If diverse spheres of private and government activity can achieve greater efficiency and effectiveness through sharing services without full amalgamation, then surely the same can be done in local government.

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### Assessing alternative structures

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The Australian Centre of Excellence for Local Government (ACELG) in 2011 took a fresh and objective look at the results of consolidation in local government both in Australasia and the rest of the world.<sup>16</sup> It concluded that:

“Ongoing change in local government is unavoidable, and consolidation in its various forms will be part of that process. As a general rule benefits of some sort do accrue when councils adopt mechanisms to collaborate or consolidate with other local authorities. Potential benefits are reduced or lost when the process is flawed due to inadequate planning and consultation or a failure to consider all the options available and precisely what each could achieve.”

Its primary research finding was that “there is little evidence that amalgamation will automatically yield substantial economies of scale. What is more obvious is that various forms of consolidation have the capacity to yield economies of scope”. It also added, “In the case of more remote councils with small populations spread over large areas, consolidation (whether amalgamation or shared services) may not be feasible”. Economies of scope come from sharing services whereas economies of scale come from purely size.

The verdict is in: Sharing services makes sense, simply getting bigger does not.

In exploring future structures of local government one should not confine oneself to the binary choice of status quo versus amalgamation. Other choices in between these extremes can achieve both the efficiency of scale (through service outsourcing) and scope (via shared services), and the effectiveness of specificity (by local place management) and speed (from codified practice with time limits). This means exploring the possibility of virtual councils.

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## Conclusion

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Local governments' share of GDP is much lower in Australia than in other countries. Yet the average residency of Australian councils is much larger than that of local government authorities in most other countries. There is no empirical evidence either here or overseas that larger councils result in lower costs, rates, fees and charges. Indeed, in NSW, larger councils charge higher rates. Mergers distract from the real issues, which are massive under-spending on capital works and dysfunctional development approval processes.<sup>17</sup>

The administrative reality is that the efficiency and effectiveness of a local council is not just a function of its size, but its speed, scope and specificity in delivering services whether processing rate notices, repairing roads, answering enquiries or considering development applications. Speed and scope require:

- Front-office place management focusing on the particular problems of a local place;
- Mid-office strategic management making strategic decisions locally and regionally;
- Back-office process management achieving economies from specialist providers.

Most council frontline services require very local attention, in which small councils excel. Urban planning and large developments need a regional focus through regional institutions. Routine corporate services and public works need scale to capture economies, which either outsourcing or SSCs do best.

The political reality is that people believe small is beautiful – they want their local council centred on their neighbourhood. Residents identify with distinct neighbourhoods not amorphous regions. People expect their local councils to address micro issues within their local community, but expect the state government or joint state/local government bodies to address wider regional issues. They want impartial authorities divorced from vested interests to determine development applications based on long-term urban planning strategies agreed at a local, regional or state level depending on the significance of the project.

Citizens should be free to decide what size municipality they want. State governments could put lower and upper limits on this, for example, 20,000 to 100,000, except for remote rural councils whose populations are small and scattered. Councils would be required to transfer those services that would benefit from being done on a larger scale to an SSC, and those decisions that need to be done at a regional level to joint regional political (for example, Regional Organisations of Councils), statutory (for example, Regional County Council) or judicial bodies (for example, Joint Regional Planning Panels).

The SSC would be jointly owned and governed by its member councils. It would be run strictly as a business providing works, maintenance, IT, financial services, planning, and so on, to participating councils, and their ROC, RCC or JRPP on a fee-for-service contract basis.

To ensure that an SSC gave value for money, there would be a sunset clause on its exclusive mandate. Thereafter, councils, ROCs and JRPPs would be free to choose alternative suppliers if they offered better value for money. The SSC would be required to cease those services for which it had insufficient clients. This would ensure it never took its clients for granted, thereby always giving them good service.

Finally, the choice for politicians and the community is not just one of the status quo versus amalgamation. Of the options available, the virtual council model would deliver the best of both worlds: small councils able to focus on local needs through intensive place and client management, but with the capacity to buy-in services economically from a regional shared service centre cooperative or a specialist private or not-for-profit provider.

If we want true reform of local government then we need to recast it, not just reassemble what exists on a bigger scale. Otherwise we risk repeating the mistake of Australia Post, which in merging its mail sorting operations created a monster in the notorious Redfern Mail Exchange.

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#### Endnotes

- 1 This paper is an abridged and updated version of pages 20-32 of the Urban Taskforce's report, *Sydney's Liveability Crisis – Reforming Local Government – Keeping the local in Local Government while improving efficiency*, Sept 2012 that was prepared with the assistance of Percy Allan & Associates Pty Ltd.
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- 3 Jones, MA 1993, *Transforming Australian Local Government – Making it Work*, Allen and Unwin, Sydney.
- 4 For references to researchers between 1992 and 1999, see Allan, P 2003, 'Why Smaller Councils Make Sense', *Australian Journal of Public Administration*, Vol. 62, No. 3, Sept, pp. 74-81.
- 5 Jones, MA 1993, op cit.
- 6 LGSA 2006, 'Independent Inquiry into the Financial Sustainability of NSW Local Government', *Are Councils Sustainable, Final Report and Findings*, Sydney, May, pp. 21-22 and 257-262.
- 7 Soul, S 2000, *Population Size and Economic and Political Performance of Local Government Jurisdictions*, research thesis submitted to the Southern Cross University to fulfil requirements for a Degree of Doctor of Philosophy, p. 179.
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- 10 Lakewood, California, *Wikimapia*, accessed at [wikimapia.org/10156810/Lakewood](http://wikimapia.org/10156810/Lakewood); Long Beach Register 2014, 'Editorial: Lakewood a model city for 60 years', Orange County Register, 20 March, accessed at [www.ocregister.com/articles/city-606374-lakewood-years.html](http://www.ocregister.com/articles/city-606374-lakewood-years.html); 'Lakewood, California', *Wikipedia*, accessed at [en.wikipedia.org/wiki/Lakewood,\\_California](http://en.wikipedia.org/wiki/Lakewood,_California).
- 11 Coase, R 1937, 'The Nature of the Firm', *Economica*, Vol. 4, Iss. 16, Nov, pp. 386–405.
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- 14 Handy, C 1989, *The Age of Unreason*, Harvard Business School Press, Boston MA.
- 15 NSW Dept. of Premier and Cabinet, 2010, *Blueprint for Corporate and Shared Services in the NSW Government*, 15 July, p. 6, accessed at [www.dpc.nsw.gov.au/\\_\\_\\_data/assets/pdf\\_file/0003/97572/100715\\_Blue\\_Print\\_for\\_Corporate\\_and\\_Shared\\_Services\\_in\\_the\\_NSW\\_Government.pdf](http://www.dpc.nsw.gov.au/___data/assets/pdf_file/0003/97572/100715_Blue_Print_for_Corporate_and_Shared_Services_in_the_NSW_Government.pdf).
- 16 Aulich, C, et al., *Consolidation in Local Government: A Fresh Look*, ACELG, May 2011, p. 7.
- 17 See Urban Taskforce assisted by Percy Allan & Associates Pty Ltd: *Sydney's Liveability Crisis – Reforming Local Government, Keeping the local in Local Government while improving efficiency*, Sept 2012.



## 3.3

# The need for strong metropolitan governance within the Federation

## Lucy Hughes Turnbull AO



Lucy Hughes Turnbull AO is an urbanist, businesswoman and philanthropist with longstanding interest in cities, and technological and social innovation. She chairs the Committee for Sydney. She is currently a board member of the US

Studies Centre at Sydney University, the Australian Technology Park, the Redfern Foundation Limited, the Turnbull Foundation and the Grattan Institute. She was deputy chair of the Council of Australian Government's City Expert Advisory Panel. Lucy Hughes Turnbull AO was the first female Lord Mayor of the City of Sydney from 2003–04. In 2011, she became an Officer of the Order of Australia for distinguished service to the community, local government and business. In 2012, she was awarded an honorary Doctorate of Business by the University of New South Wales.

Australia is one of the most highly urbanised countries in the world. Eighty per cent of our population live in cities with more than 100 thousand people and over 60 per cent living in the four largest state capitals, Sydney, Melbourne, Brisbane and Perth. These cities are also some of the lowest density metropolitan areas in any developed country. This creates a lot of congestive pressure: the farther flung the population and the farther from employment, the greater the demand for longer road trips, thus roads, and very spread out public transport networks, where available.

Our cities are the biggest engine rooms of our economy. Today, our cities are held back by inadequate systems of governance and the chasm between higher level metropolitan planning at a state government level, and the delivery and fulfilment of those plans at the local government level.

Goldilocks and the three bears is an effective analogy: Federal Government is far too big to play an ongoing role in metropolitan governance; state government is not as big as Federal Government, but it has competing priorities in regional and rural areas; and local government, being 'baby bear', is far too small to shoulder the burden of well-coordinated and integrated planning – land use, transport, infrastructure, economic planning for any entire metropolitan area (with the notable exception of Brisbane).

In three of the four large metropolitan areas – Sydney, Melbourne and Perth – local government is too small scale to do other than very locally focused place management. Cities are not just places, they are systems – economic, transport and social systems – that must be integrated and well distributed. State government, doing all the work in delivering systems, often inevitably has a silo-based approach to cities with low levels of integration between transport and land-use planning. Sometimes the different systems fail to speak to each other. And this lack of integration is the other key problem of metropolitan governance.

Metropolitan governance is essential if our cities are to be the prosperous, productive and liveable places they need to be to ensure national prosperity. Everyone around Australia has a real vested interest in how well our cities are run, however far away from them they may live. Stronger and more effective metropolitan governance is fundamental to Australia's future success.

Stronger metropolitan governance would deliver clear-sighted focus that understands the important of place management, good design and liveability, as well as the delivery of good systems that any great city needs.

Of our state capitals, only Brisbane has a city government that actually governs the whole city. The Kennett Government in Victoria consolidated councils in the 1990s, but arguably did not go far enough, and what was achieved came at a high political cost. Perth is attempting to tackle the problem now. Sydney has yet to do so and the city has suffered with congestion, poor growth management and low housing affordability as a result.

Because of the small scale of local government, there is an uncomfortable and often a fraught tension between state and local government, particularly in New South Wales (NSW), with much less trust and confidence in the planning system and our governance than there should be.

Under-sized, under-capacity, disempowered local government makes it much harder to manage population growth and demographic change. Large metropolitan regions must become polycentric, where there are well-distributed urban centres with levels of economic activity and job density, to reduce congestion and long travel times. Small local governments, as well intentioned and hard working as they are, simply cannot

deliver the outcomes necessary. They don't have the power and they don't have the means. Stronger metropolitan governance may make the difference between our cities being truly successful and globally competitive or not and gradually losing their competitiveness as well as their prosperity. Our cities' decline will also bring national decline.

It is time for a new federal compact that acknowledges the importance of strong metropolitan governance, and for a clear understanding of which level of government is responsible for what.

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## Historical context

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Like the tiny hamlets and villages that were the nucleus for the creation of local government for most of our metropolitan areas (even city governments were not very big), local government is still small scale, despite the growth of our large cities into conurbations. Each local government forms only a small sliver of the metropolitan whole. Metropolitan government is very small scale compared with other cities in our peer group.

In the mid-19th Century, many decades before universal suffrage, colonial (now state) governments were seen as being run by the few, not by the many. Local governments were often created from a strong urge for those who were not part of 'the few' to have democratic representation. To a considerable extent, local government was formed by a democratic impulse on the part of small communities. In fact, some of the 'few' who held power in the colonial legislature in NSW resisted the creation of local government because it meant that there would, necessarily with representation, be a new tax on land in the form of council rates.

These small and very local historical origins of local government cast a big shadow on the way local government operates today, in Sydney in particular, but our other large major metropolitan cities as well. It has always been very fragmented, built around tiny settlements and hamlets. The biggest exception to this is Brisbane, which, due to some inspired political leadership in 1924, merged 20 local governments into Brisbane City Council. This has been to Brisbane and South-East Queensland's great advantage ever since.

As our urban populations exploded from the mid-1850s, so did the number of local governments. And most Australian cities did not, as many other large cities in the English-speaking world and Brisbane did, unite local government into a larger, stronger, more empowered whole.

The biggest example is New York, when what are now the five boroughs – Manhattan, Brooklyn, Queens, the Bronx and Staten Island – merged into one big metropolitan government. The new City of New York created the governance framework to make the great urban moves of the late 19th and early 20th centuries possible, such as what is now the lifeblood of the city, the subway that runs across the length of those five former separate boroughs. There were other great results of strong metropolitan government as well: the bridges, the highways, and later, the airports. This strong metropolitan governance model set the framework that made it possible for New York to become the financial and economic capital of the free world.

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## Where we are today

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### The deficit of metropolitan governance

Many Australian cities, above all Sydney, now have what can only be called a significant metropolitan governance deficit compared with many other cities in the developed world, such as New York, San Francisco, Chicago and Singapore, which is really a city-state. In addition, London is located very much at the centre of British Government unlike the national capitals in Australia, the United States (US) or Canada. Despite its centrality and the lack of state governments layered between local and national government in the United Kingdom (UK), the British Government felt the need to re-establish a Greater London Authority in the last years of last century to establish a stronger system of metropolitan governance to support London's role as a great world city.

Australian state governments, for perfectly understandable reasons, have competing priorities in rural and regional areas. Despite these other priorities, the issues of transport and land-use planning, water supply and storage (everything, in fact, that we would call infrastructure today, except local roads, footpaths and local parks) were put squarely at the foot, if not landed in the lap, of colonial, later state government. This was a function of the size, resources and thus the capability of local government to be able to do any more.

The deficit of metropolitan governance has made it really hard to manage growth in a coordinated and effective way, particularly in Sydney. On the one hand, the noble principle of subsidiarity – that decisions should be made as locally, at the lowest level of government possible – has made metropolitan governance much more difficult. The smaller the community, the harder it is to grasp (beyond local level) place management, and to understand how important it is to manage population growth and systems growth in a wider metropolitan context.

The reflexive view at a local level can sometimes be that “managing wider national and metropolitan population and economic growth is not our problem”. The mandate of local government councillors is to serve the local community, and that means today's local community, not the wider metropolitan community. And there is often a low level of focus on intergenerational equity. At the scale in which local government operates, it is a rational and completely explicable response to say “we are small, we like the way things are we do not want any change. Do whatever you need to but don't do it in my street or backyard”.

Fragmented metropolitan governance cannot by definition have the strategic capacity to plan and deliver what is needed to manage population growth, nor the resources to make the necessary investment in infrastructure. In addition, small-scale local government does not have the administrative reach or the broad political mandate needed to manage growth in a positive way that delivers the housing, the jobs, the prosperity and liveability or to ensure processes that will prioritise productivity and prosperity as well as community.

The fact that our state governments are principally challenged with building the infrastructure and setting the strategic tone for planning our large cities means there is often a dual and clear tension between government departments and agencies charged with delivering systems, and economic planning, treasury and finance departments with their concentration on minimising debt and capital expenditure. Often each system operates within its silo area and there is no ‘coming together’, consensus or

accord between these government departments, none of whose core business is place making, but rather, systems or service delivery. Stasis and inertia are often the result. Either that or the reverse where there can be sudden fitful spurts of activity from a particular agency or department without any clear cohesive or integrated internal logic from a whole of government perspective, or from the perspective of the whole metropolitan region. This is bad governance. And very bad for sound planning and management in their widest senses.

A Swiss academic, Daniel Kubler, a political scientist from Zurich who has studied Australian metropolitan governance in some detail, has noted that conflict between the NSW Government and local government in metropolitan Sydney:

“... increases the likelihood of blockades within the joint decision system ... as a consequence of failed structural reforms (that is, council amalgamations which are often seen as being politically motivated) the geopolitical fragmentation of the Sydney metropolitan area is high, but quite typical of Australia. Indeed in international comparison, Australian metropolitan areas are roughly three to 10 times more fragmented than their comparable counterparts on other countries, such as Canada, for example. Only Brisbane – thanks to the annexation of 20 suburbs in 1924 – has an institutional structure that is comparable to the situation found in other OECD countries ... (the most significant tension for metropolitan governance) is the one leading to conflicts between local councils, and the states. It stems from the tension between local interests and the regional scope necessary for planning the development of the wider metropolitan area.”<sup>1</sup>

Kubler went on to observe that state government-initiated metropolitan planning strategies can be delivered only with the support of local government, and that the compliance of local government with state-wide metropolitan objectives cannot be assumed:

“There is a dilemma of how to reconcile local government’s day-to-day control of new developments with the pursuit of longer term and metropolitan-wide strategic aims. Resolving this dilemma is the key to achieving area wide governance in Australian metropolitan areas.”<sup>2</sup>

### Vertical fiscal imbalance

We need to understand the problem in the context of the current significance of metropolitan regions to a nation’s economic success. Many learned authors have written about this, Edward Glaeser and Enrico Moretti to name just two. The title of Glaeser’s recent book, *The triumph of the city – how our greatest invention makes us richer, smarter, greener, healthier and happier*,<sup>3</sup> says it all.

It’s important to understand the challenge of metropolitan governance within the scope of our current system of federalism. Our federal system is characterised by extreme vertical fiscal imbalance. The Commonwealth Government raises nearly all (approximately 75 per cent)<sup>4</sup> total government revenue, and delivers many of the really expensive services (welfare payments to name a big one). It then provides tied and untied grant funding to the states of just under half the states’ total revenue, and distributes direct federal funding to schools, hospitals, roads and infrastructure, which are not, strictly speaking, its responsibility. This direct distribution creates the expectation that the Commonwealth Government (whoever is in power) will come to the financial rescue of any deserving urban project – because no other level of government is financially able.

In the middle of World War II, state governments relinquished the power to levy income tax or any other major taxes, and they have not been very keen to take that

responsibility back. State governments levy some taxes – principally stamp duties, land tax and payroll taxes – and deliver almost all the services and systems to metropolitan areas and elsewhere. State governments build and run the hospitals, schools, roads, trains, and set the strategic planning framework for metropolitan government. They are the level of government most intensively engaged in the business of service delivery in our metropolitan regions.

### Who does what?

Which level of government does what has become very blurred in recent decades in response to an understandable collective, bipartisan political response to community pleas to stop blame shifting and just fix things through financial assistance, direct or otherwise. But it has confused who is responsible for doing what. So the picture will continue to be confusing absent a major renegotiation of the federal compact.

We now have the confusing, even for some, confounding situation in which the current Commonwealth Government is prepared to provide funding for roads and highways but not for urban rail – at a time when good mass transit is known to be a major productivity, liveability and international competitiveness-enhancer and congestion-reducer in all cities, our own included.

Poor metropolitan governance confounds the issue of who is responsible for what. It thereby reduces accountability and leads to blame and cost shifting, which is the opposite of good governance.

This is an even more fundamental issue when it becomes clearer and clearer that in the post-resource construction boom in the coming years and decades, it will be the capability and the productivity of our human capital – otherwise known as our people – that will determine future national success. The resources sector accounts for around half of our export earnings but less than 15 per cent of our gross domestic product (GDP). Our GDP is overwhelmingly sourced from the material between our collective ears, and will be for the foreseeable future.

And people overwhelmingly live in our large cities. Our cities generate 80 per cent of our GDP. So it is in our cities that we face the biggest national challenges – ensuring continued economic growth and higher productivity, and managing demographic change (with increasing pressure on the health system) and population growth. With an ageing population, there will be fewer working-age people for each person aged over 65 (traditionally thought to be over working age). In 1970, there were seven working-age people for each person over 65; in 2010, there were five; and by 2050, there will be 2.7. That will take us, approximately, to where Japan's demographics are now, which will put a lot of pressure on the need for those who are in the workforce to work more productively than they do today.

Demographic ageing and other societal forces mean that the fastest growing household type is the single-person household. Between 2006 and 2031, there will be a 30 per cent increase in single-person households – 1.3 million. Many of these single people are women. Thirty per cent of women will reach retirement age without a partner.

These combined forces will enhance the need for more compact, denser, walkable or transport-accessible communities. Added to this is the new phenomenon of younger families being increasingly willing to trade space and quiet suburbia for inner-city compactness and convenience – the dominance of the two working-parent households with children makes this inevitable.

These demographic and societal forces lead to the need for more compact housing choices and denser settlement. This will put a great deal of pressure on our defective metropolitan governance system to deliver the housing that is not only wanted, but needed. Without reform, the tension and the dissonance that Professor Kubler described will become even more intense. We just won't get the cities that we need and want for the future.

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## Where we need to go

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There is often a big, even chasmic gap between the discussion about macro issues raised in national policy like the Intergenerational Reports and the micro discussions about, for example, whether a row of buildings in a neighbourhood should be single, two or three storied or more. But they are all part of the same puzzle and even the same conversation, and need to be mutually respected as such.

Our cities are a matter of strategic national importance and deserve a lot more 'big city thinking'. As the locus of so many of our people and so much of our economic output, they have to be.

At a metropolitan level, productivity can be enhanced through flexibility, such as flexible trading hours, flexible work practices to include wider sections of the population, and higher workplace participation, good education standards and skills training, investment in productive infrastructure and not too much congestion.

Productivity can also be enhanced through working with the economics of agglomeration: These agglomeration benefits are strongest where workers, businesses, products and suppliers are all close to their markets. This is particularly true for the high value-added services that are concentrated in our cities, such as financial and business services, and the ICT industries. But agglomeration cannot just happen in our CBDs alone. It has to be clumped through metropolitan regions. The only successful large metropolitan region this century will be a polycentric 'city of cities'.

Productivity at its core, as dry as it sounds, means making the best use of our resources – our people above all – so that we can do more with less. More outputs with fewer inputs. Productivity is much closer to the real notion of sustainability than is often understood.

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## How do we get there?

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1. Encourage smaller local governments to find pathways to amalgamation to create and benefit wider communities of interest. This can be through giving greater responsibility, powers and financial capacity to larger scaled local government. The carrot will always work better than the stick.
2. Build stronger subregional planning into the system and create clear accountabilities for it. There will always be a discussion around how many subregions there are for our large cities, and there will never be 100 per cent consensus about where the lines should be drawn. But it is possible, and it is a very important element of stronger metropolitan governance. In an ideal world, local governments would cover the same territory as each subregion of larger metropolitan areas. That way, local

government can be empowered to do the important job of subregional planning that always falls to state government, and not always successfully for the aforementioned reasons. That way too, the principle of subsidiarity could really work.

3. Metropolitan planning commissions could be a way of bridging the gap between under-scaled local government and arguable overscaled state government. It could be the all-important bridge between local place management, and systems planning and subregional planning. Metropolitan planning commissions will only work if the various key functions and service delivery areas of government are included and are part of the team – together with more empowered, larger local governments so that governance in our cities can be well integrated and coordinated. Larger and more empowered local governments will be able to play a greater role.

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## Conclusion

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If we don't tackle the metropolitan governance problems we have, our cities will not go into sudden decline. But they will, over time, fail to fulfil their true potential. And everyone, present and future, will be the poorer for it. No city in the competitive globalised world can thrive with weak and fragmented governance where the fight between localism and metropolitan 'big city thinking' is an ongoing battle with uncertain, fraught and adverse outcomes.

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### Endnotes

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## 3.4

# Providing public infrastructure in Australia

## Bree O'Connell and Brad Vann



Bree O'Connell is a senior lawyer at Clayton Utz in the Construction & Major Projects Group but began her career as a corporate lawyer advising on compliance and fundraising issues.

She has extensive experience advising the Department of Defence on major infrastructure and redevelopment projects, and she was a part of the team advising AquaSure on equity matters in relation to the Victorian Government tender for the design, construction and operation of the desalination plant in Wonthaggi, Victoria.

Bree has recently been advising on the Productivity Commission's report into public infrastructure and infrastructure matters raised in the Second Phase Report of the National Commission of Audit.



Brad Vann is a partner at Clayton Utz and advises on the financing and delivery of large-scale infrastructure projects, having worked with governments, sponsors and banks for over 30 years.

Brad has advised on social and economic infrastructure in Australia and Asia. He is currently advising Linking Melbourne Authority and the State of Victoria on the East West Link project, having originally assisted Sir Rod Eddington on his East West Needs Assessment Study in 2008.

Brad assisted the Committee for Melbourne in its discussion paper, *Moving Melbourne*<sup>1</sup>, in 2012 and he published a discussion piece<sup>2</sup> for *Business Spectator* in 2013. Many of the ideas promoted in these materials have been publicly debated as real options for delivering infrastructure in Australia.

Infrastructure – who should build it, maintain it and, ultimately, pay for it – continues to be a regular feature of political, industry and media commentary and debate. Paradoxically, infrastructure, despite the fact that it is usually large and physical, is generally treated by the public as invisible. It is only when it fails that its existence is acknowledged.

Failure can be catastrophic, such as a bridge collapsing, an issue that is particularly troubling in the United States these days. More commonly, the failure is gradual, as the infrastructure fails to deliver the level of service that the public expects, such as the current debate in Australia regarding our public transport systems.

Infrastructure usually involves significant expenditure, so the planning for it is usually very long term. It is for this reason that historically governments plan, deliver and fund infrastructure.

New forms of financing are being explored due to constraints affecting government budgets, and the fact that Australia's constitutional framework doesn't match the responsibility for delivery of infrastructure or the ability to fund it effectively.

This chapter proposes that public infrastructure shares many characteristics with telecommunications carriers, thereby providing a basis for adopting the infrastructure policies of telecommunications carriers for the provision of public infrastructure in Australia.

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## Infrastructure: The key to growth

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### Defining Australia's public infrastructure problem

There are two main parts to Australia's public infrastructure problem.

The first part of the problem is reflected in public infrastructure deficiencies. Australia's public infrastructure is ageing, its maintenance requirements are increasing, and many public infrastructure assets are reaching, or have reached, user capacity. The state of the nation's infrastructure is in decline, and with it, the efficient functioning of its cities and regional areas.

The Productivity Commission referred to widely held views that deficiencies in Australia's infrastructure are holding back productivity growth and affect the amenity of cities and regional areas.<sup>1</sup>

Ageing, inefficient infrastructure and infrastructure deficiencies increase costs and create barriers to population growth, and more importantly, workforce growth. They also increase costs to business and reduce productivity.

Australia's infrastructure problem is the congestion on roads, and at ports and airports. Public transport systems are plagued by overcrowding and disruptions to service caused by breakdowns and signal failures. Water wastage is being caused by broken pipes and leakage from irrigation channels.

Infrastructure deficiencies are a huge economic burden. The social costs of congestion in Sydney alone have been projected to exceed \$7 billion by 2020, and it has been estimated that by that time, the cost of urban congestion to the national economy will exceed \$20 billion.<sup>2</sup>

The second part of Australia's public infrastructure problem is reflected in the vertical fiscal imbalance created by the Commonwealth Government collecting revenue

in excess of its spending responsibilities (through the collection of income tax, Goods and Services Tax (GST) and fuel excise) and the state governments having insufficient revenue to finance their spending responsibilities. The effect of this vertical fiscal imbalance is two-fold:

1. The states do not raise enough revenue (from the collection of property and vehicle taxes and payroll tax) to invest in public infrastructure without Commonwealth Government assistance; and
2. Any increase in revenue generated by increased economic activity flowing from investment in public infrastructure goes to the Commonwealth Government rather than to state governments.

While state governments are best placed to deliver public infrastructure because of their connection with the communities to whom they supply relevant services, the vertical fiscal imbalance paradoxically creates a considerable disincentive for state governments to invest in public infrastructure. This effect is magnified when taking into account the income foregone because of diminished economic activity flowing from the deficiencies in public infrastructure, for example, missing out on increases in property taxes because of reduced growth in property values.

### Benefits of investing in infrastructure

Investing in new infrastructure and the maintenance or upgrading of existing infrastructure provides both economic and social benefits, directly and indirectly, for all Australians.

Economic infrastructure is infrastructure that directly serves the economy, such as roads and ports. Such infrastructure enables business to reduce costs and improve productivity.

Social infrastructure serves a social function, such as schools and hospitals, and these arguably have an indirect effect on the economy by improving education and health to alleviate the burden on welfare.

Direct economic benefits can be measured in terms of reduced costs (in time or money) or increased revenue. Access to a new road directly benefits road users by reducing the time of a journey and therefore the fuel and wear-and-tear costs of a vehicle. New road infrastructure also benefits businesses and consumers by reducing the time and cost of providing goods and services.

Indirect economic benefits are benefits felt more widely because of the direct economic benefits. Improvements in business productivity and profit that flow from cost reductions or increases in volume can lead to greater investment by business in employment or capital works.

The social benefits of infrastructure can be measured by improvements in quality of life or amenity. Schools and hospitals provide obvious direct social benefits, such as education and health to students and patients. They can also indirectly benefit the wider population by reducing the spread of illness or reducing reliance on welfare by improving employment opportunities.

Furthermore, infrastructure can provide both economic and social benefits concurrently. In addition to the health benefits that hospitals provide, improvements in community health can contribute to a greater participation in the workforce because of less absenteeism due to illness. Over and above the economic benefits of a new road are the social benefits of improving access to services that hospitals and schools provide.

Investment in infrastructure is important to enable the nation's cities and regional areas to grow. It is both the economic and social benefits of infrastructure that attract and retain people. Investment in infrastructure is needed to provide:

- An acceptable cost of living;
- Employment opportunities;
- Access to services; and
- A satisfying level of amenity.

As cities grow, the economy grows, and a failure to address Australia's infrastructure problem will make it more difficult to attract the kind of people who will contribute to economic growth.

### Responding to the infrastructure problem

Any response to the public infrastructure problem must focus on investing in public infrastructure in our major capital cities, and more specifically, central business districts (CBDs). CBDs are Australia's economic growth engines. They have been experiencing compound annual growth of 3.5 per cent over the last decade or so, with many exceeding 4.4 per cent growth. Australia's major capital cities are among Australia's top 10 economic contributors.<sup>3</sup>

The response to the public infrastructure problem should be driven at the federal level of government. Both the Productivity Commission and the National Commission of Audit acknowledge the paramount role of the states in identifying and delivering infrastructure. This is consistent with the distribution of powers under the Constitution, which leaves the responsibility for infrastructure in the hands of the states (by omission). It also recognises that most infrastructure will benefit users and residents within a particular state, so the state governments are in the best position to assess the merits of an infrastructure project to meet local needs.

However, this responsibility vested in the states ignores the vertical fiscal imbalance and the fact that the Commonwealth Government holds the purse strings. The states rely on receiving a proportion of the GST collected by the Commonwealth Government to cover their spending commitments. So despite the states' constitutional infrastructure powers, they depend on federal funding to enable them to deliver local infrastructure.

Given the benefits of investing in infrastructure for the nation as a whole, the Commonwealth Government's relative financial strength and ability to analyse national networks for more efficient provision of infrastructure mean it has considerable power and scope to set the policy for investment in Australia's infrastructure.

Arguably, the Commonwealth Government's two main roles are coordinating the development of nationally significant infrastructure and linking federal funding with requirements for efficient infrastructure delivery by the states. The former is well in hand with the recent amendments to the constitution of Infrastructure Australia. The latter is still a work in progress.

However, adopting a CBD focus along with Commonwealth Government coordination and funding will not necessarily lead to better infrastructure outcomes without also taking into account the private sector's approach to investing in infrastructure and ensuring there are links between the delivery of infrastructure and usage.

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## Nature of infrastructure assets

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Public infrastructure assets share many characteristics with the infrastructure assets of telecommunication carriers, which provide a basis for state governments to act like telecommunications carriers in making infrastructure investment decisions.

### Part of a network

A telecommunication carrier's infrastructure is a network of copper and fibre optic cables, and related technology. In a similar way, public infrastructure can be viewed as a network, one made of electrical wires, gas lines, water pipes, roads and rail.

### Natural monopolies

Most public infrastructure assets are natural monopolies. Natural monopolies occur when no competitive market exists because it is more efficient for one provider to supply the relevant market than for two or more providers to do so.

The sheer size and cost of most infrastructure mean that large economies of scale are required to produce an efficient outcome, which creates a natural barrier to competition. Duplicating infrastructure assets would increase the average cost of providing the service and would be a wasteful use of resources. It would be useless to have two bridges, side by side, providing an identical route to one destination. It therefore makes sense that the provision of public infrastructure has traditionally been the domain of government.

However, being a natural monopoly doesn't have to mean that a public infrastructure asset is destined to be the sole domain of governments as is arguably demonstrated by certain characteristics that public infrastructure shares with telecommunications carriers.

A telecommunications carrier provides the infrastructure used to provide telecommunication services. It has the characteristics of a natural monopoly because it is inefficient to duplicate the infrastructure to create a competitive market. However there is clearly a free market in telecommunications services because multiple telecommunications service providers are allowed to share the existing infrastructure to provide telecommunications services to their respective customers.

### Regulated market

As a result of its natural monopoly, the Commonwealth Government has intervened to impose a regulated market on the telecommunications carriers to ensure that consumers are not disadvantaged by the conditions of the natural monopoly, which creates the potential for higher prices and lower levels of delivery than would be achieved in a competitive market.

Public infrastructure is not subject to a regulated market per se; however, political necessities, such as the need to provide equitable access to basic services to users regardless of their ability to pay, potentially have the same effect on access and price.

### Approach to investing in infrastructure

From the advent of morse code and the telegraph, to telephones and exchanges and then to mobile phones and towers, telecommunications carriers continually invest in new and existing infrastructure. If they do not, it will be difficult to maintain service levels as breakdowns increase, and it will then be difficult to retain and attract customers. Carriers would also miss out on the benefits of adopting new technology, such as reduced input costs, and the potential for new or increased revenue.

Failure to invest in public infrastructure has a similar effect on a city's ability to retain and attract people, and it leads to lost opportunities for cost efficiencies or economic growth.

A telecommunications carrier benefits from agglomeration economies that occur when a large number of users are able to share the same infrastructure thereby reducing the cost of delivery to each user. The telecommunications carrier is then able to provide the service to locations that are more remote.

Although the provision of telecommunications infrastructure to rural areas is less efficient because there are fewer users and delivery costs are higher, there is recognition that absorbing the higher cost of providing that service has many benefits, such as broadening its market, creating loyalty and providing an expanded service to its customers. It is the infrastructure that services the many that provides the opportunity to provide infrastructure to service the few.

The same principal applies to governments. The provision of public infrastructure to cities delivers the opportunities to provide infrastructure to the regional areas because of the economic growth it generates. Despite the higher cost of providing regional infrastructure, there are economic and social benefits in doing so.

There are two significant points of difference in the telecommunications carrier's approach to investing in infrastructure. These points of difference are exactly the issues that a response to Australia's infrastructure problem needs to address. The first is that the vertical fiscal imbalance disincentivises state governments from investing in public infrastructure because increased revenue flowing from economic growth bypasses the states and goes straight to the Commonwealth Government. The second is that the telecommunications network is supplied on a user-pays basis.

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## Delivering infrastructure on state government budgets

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### Traditional funding approach

Historically, governments have taken the lead role in providing and funding infrastructure in Australia. Before the 1980s, the public sector owned and financed most infrastructure, and private enterprise constructed it under a system of competitive tendering.

In the 1950s, the public sector provided, operated and maintained 92 per cent of the nation's infrastructure. By 2002, this had reduced to 71 per cent, largely due to privatisations. However, still a significant proportion is in public ownership.

In general, privatisation of important public assets has been, and continues to be, politically unpopular.

The recent budget cuts highlight the Commonwealth Government's reduced appetite for debt, which will inevitably constrain its capacity to invest in new infrastructure projects and maintain existing infrastructure assets. In addition to budget cuts, the Commonwealth Government is contending with an unsustainable decline in fuel excise revenue because new technologies have led to lower fuel consumption, which reveals the flaw in linking revenue with a measure that does not reflect actual use. Therefore, the need for more innovative funding options is apparent.

There is now a clear trend towards reducing government ownership of infrastructure assets, and ensuring that government investment in infrastructure be tied to transparent cost benefit analysis, and charging users for the services provided by infrastructure.

### Transparent pricing with hypothecation funding of service delivery

Part of the response to Australia's infrastructure problem needs to consider options for increasing revenue – through either the introduction of new taxes or user charges, both of which tend to be unpopular. In Hong Kong, a congestion charge was rejected, despite positive results from models, because of a perception that it was a revenue raising exercise.<sup>4</sup>

However, public support for user charges can be achieved provided there is a clear link between use and service. For instance, explicit opposition to London's congestion charge was over 40 per cent prior to its introduction, but fell by almost half within three months. Explicit support for the charge rose to almost 60 per cent over the same period.<sup>5</sup>

Similarly, there appears to be significant evidence that the level of public support for new taxes is higher if revenues are hypothecated to investment in tangible benefits. For example, support for an increase in tobacco taxes was found to increase from 47 per cent to 84 per cent if hypothecated for health or other community benefits.<sup>6</sup> A proposal in LA County to introduce a new sales tax hypothecated to the delivery of 12 new transport projects over 20 years received the support of 75 per cent of voters.<sup>7</sup>

Regardless which funding option is used, in addition to increased public support, one of the benefits of transparent pricing with hypothecation funding of service delivery is that it provides users with a better understanding about the balance between the cost they pay and the level of service they receive.

It can also lead to a more efficient use of the service as each user makes an assessment of the costs versus the benefits of use. A congestion charge is a good example, as users who determine that the benefit in using a road subject to a congestion charge is no greater than the benefit in using an alternate route will alter their use accordingly. This allows a more efficient use of the charged road by alleviating congestion.

Transparent pricing with hypothecation funding of service delivery can also lead to more equitable pricing for a service by ensuring that the users deriving the most benefits from the service are making the greatest contribution to the provision of the service. For example, current road-related charges in Australia, being vehicle registration fees and fuel excise, lack transparency and are linked to the nature and fuel efficiency of a vehicle rather than the use of roads. When one considers also that fuel tax credits are provided to heavy vehicles, it is clear that potentially those users who derive the most benefit from the roads make comparatively smaller contributions to the provision of roads and road maintenance.

### Linking delivery of infrastructure with use of the asset

For some infrastructure assets, the obvious link between delivery and use will be user charges. Road users should pay a road charge to reflect the cost of providing access to, and maintenance of, the roads. Utility users pay consumption charges and service fees to reflect the cost of goods and to provide access to, and maintenance of, the pipes or power lines.

If users can be charged for the service of an asset, that asset should be capable of generating a commercial return. This return should be used to attract private sector involvement in the provision of the asset.<sup>8</sup>

In some cases, user charges will not be appropriate. However, the service will still provide net economic or social benefits. In these cases, user charges, even with transparent pricing with hypothecation funding, will not be appropriate. There will also be situations in which the level of user charges cannot meet the spending requirements of the service delivery. For example, the level of public transport fares and volume of passengers is not sufficient to meet the cost of providing the service.

Value capture mechanisms provide an innovative way to link delivery with use of an asset beyond the direct user to a broader group of beneficiaries. It also spreads the cost of service delivery across them. This may be a useful way to link delivery with use where user charges would not meet funding requirements or would not be appropriate.

While there are many types of value capture mechanisms, the common thread between them is that they seek to impose a cost on those who benefit from the efficiencies and improvements in amenity created by the infrastructure to which they are attached. For example, there is evidence that residential property values in the transit catchment area of a rail transit project can increase by up to 45 per cent. The impact is even greater on commercial property in the catchment, with up to a 65 per cent increase in value.<sup>9</sup>

A betterment levy such as the Business Rates Supplement imposed on businesses in London in connection with London's Crossrail project seeks to capture a portion of the increases in property values or commercial value created by the delivery of new infrastructure.<sup>10</sup> Tax Incremental Financing (TIF) seeks to capture increases in tax revenue that are expected to be created from rising property values (land tax) and improved business profitability (business income tax). A TIF was introduced as part of the Dallas Area Rapid Transit (DART) project in 2008, which was expected to deliver US\$328 million in incremental tax revenue based on the increase in property values from US\$320 million in 2008 to US\$3.52 billion by 2038. Studies already suggest that the value of properties near DART stations is between 12.6 and 13.2 per cent higher than elsewhere.<sup>11</sup>

Investments in infrastructure by a telecommunications carrier will be funded from its profits. Where existing profits are deficient, investments will be funded from future profits (the projections of which can be used to obtain finance from banks or investors). It is therefore reasonable to consider funding public infrastructure from future increases in tax revenue. Banks or investors require sound economic rationale to support their investment. Politicians and taxpayers are no different, which is why project assessment needs to take into account the financial value created by the project.

However, the application of these approaches will always be problematic because of the different taxes levied by different levels of government in Australia. Local authorities will benefit from rates that increase as property values increase. In addition, state governments will benefit from increased stamp duty and land tax arising from those increases. The main winner, however, is likely to be the Commonwealth Government,

with increases in income and capital gains taxes arising from those increases in value. The paradox, as noted previously, is that the states are primarily responsible for delivering the infrastructure that leads to these increases. This suggests that hypothecation of user charges is a perhaps a more desirable approach, as it avoids these difficult constitutional issues.

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## Conclusion

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Economic infrastructure underpins the performance of Australia's economy. It is imperative that we continually invest in and maintain our stock of infrastructure to ensure Australia remains globally competitive.

A telecommunications carrier enjoys a regulated monopoly return; the same logic could be applied to the provision of substantial economic infrastructure. Hypothecation of those user charges to the investment in, and maintenance of, the asset means that the community is more likely to recognise the benefit of investing in, and paying for, that asset.

The public prefers a more transparent link between the two. Politicians undoubtedly will be attracted to propositions that are electorally more compelling.

The challenge is that purely having a link between revenue and expense doesn't necessarily account for externalities, such as environmental impacts.

Not all infrastructure is capable of hypothecation, but certainly where it is, it should be required to be considered in making investment decisions.

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### Endnotes

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## 3.5

# Roles and responsibilities in the Federation

## Tanya Smith



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## Why we can do better than a ‘grand bargain’ to resolve overlapping roles and responsibilities

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Whenever the issue of duplication of Commonwealth and state responsibilities in the Federation rears its head, commentators tend to offer up either of two ‘solutions’:

1. Revert to the original constitutional arrangements – the idea that the nation’s Founders got it right at the beginning and we should invoke and apply the rules as originally intended. In other words, we should restore a clearer divide between national security and commerce-related functions that the Commonwealth performs and social services provided by the states.
2. Negotiate a ‘grand bargain’ to trade-off responsibilities between the two levels whereby the Commonwealth retains control of, for example, health, in exchange for giving states full responsibility for, say, schools.

Both approaches rest on a foundation of federalism principles that create a tension between ‘subsidiarity’ – that is, that functions are performed at the lowest level of government practicable – and ‘national interest’ where nationally important issues are managed at a higher level in the system.<sup>1</sup>

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## Problems with the traditional way of thinking about roles and responsibilities

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There are a couple of things wrong with the two ‘solutions’ when thinking about delineation of roles and responsibilities in the Federation.

First, the fact that the debate has not progressed despite these offered solutions shows that they don’t necessarily help. Why? Because the centripetal forces in our Federation are such that neither is practical. In a world of complex interdependencies, it has become too difficult to draw a clear line of responsibility between discrete portfolio areas. Meanwhile, citizens’ expectation of governments to ‘do something’ in the wake of a scandal or crisis continues to grow. This, combined with the desire of politicians to influence or take the lead on important areas of government activity, creates an imperative for involvement in an issue that compromises efforts to establish and sustain a pure division of responsibilities between the top two levels of government.

Secondly, although subsidiarity and national interest are important concepts, people will often presume that when the former prevails, state responsibility for the issue is implied. Conversely, when national interest is the overriding concept, the assumption is that the Commonwealth should be in control. With increasing globalisation, however, the subsidiarity principle may point towards national-level responsibility for an issue or service, while national interest issues need not suggest that sole responsibility should rest with the Commonwealth. Indeed, if a matter is crucially important to the nation – think of Australia’s response to the threat of terrorism post-9/11 – then it is likely that all nine jurisdictions need to be involved to address it. In other areas, it is possible to achieve a national approach or response to a problem through inter-jurisdictional coordination among states, without the need for Commonwealth involvement.

In a federation, unlike in a unitary state, power is both divided and shared.<sup>2</sup> This produces a number of benefits that have been variously described<sup>3</sup> but can be summarised as follows: A federation ensures equity in treatment of all citizens while

enabling choice, providing checks on power, promoting pluralism in our democracy and supporting innovation.

Delivering those benefits requires power to be divided and shared in a way that is:

- *Effective* by spreading risk and responsibility between levels of government, allowing for specialisation, innovation and alignment with need; and
- *Efficient* by avoiding duplication and overlap of activity, and thereby supporting an efficient allocation of government resources.

The subsidiarity principle conflates efficiency and effectiveness considerations into one concept, and begs further questioning to understand what is meant by responsibility resting with the lowest level of government practicable. Efficiency and effectiveness, while still subject to considerable interpretation, are more measurable than ‘subsidiarity’. They allow us to pose very specific questions, even if the answers are not straightforward, such as, ‘which layer of government can be most responsive to client needs?’ and ‘which layer of government can deliver the services at lowest cost?’

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## A better way to think about delineating roles and responsibilities

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So how should we approach the problem of overlapping roles and responsibilities in our Federation?

‘Responsibilities’ is usually taken to mean ministerial portfolios such as defence, infrastructure and health. While rarely considered in detail, ‘roles’ would most sensibly refer to the main functions exercised by governments. These fall into three main categories:

1. **Service delivery** – program or grants management and provision of services whether they are universal or tailored; in-person or online; information, entitlement or product-based.
2. **Regulation** – interpreted as the responsibility to ensure compliance with legislated or administrative standards or contractual obligations. This can be done within government by an arms-length regulator that is typically accountable to a minister.
3. **Policymaking** – processes associated with policy advice, development and implementation, including legislative and regulatory policy and support for decision-making processes (notably Cabinet and budget processes).

One of the problems with federalism debates to date is that the participants often trip up on the issue of ‘funding’ as a role of governments in a federation. Funding, more correctly, is an enabler of the three broad functions listed above. The fact that funding distribution among jurisdictions is being considered (via the tax review) in parallel to the *White Paper on the Reform of the Federation* underlines this important distinction and makes a breakthrough on federal reform a genuine possibility. Funding must align to the business being carried out by the respective governments, but it is the cart that goes *after* the horse.

If it is unrealistic (as argued earlier) to remove duplicated *responsibilities* by either returning to the status quo ex ante or negotiating a grand bargain that will ‘stick’, then it may be possible to get closer to a solution by focusing instead on who performs which of the three key *roles* within a given area of responsibility. Could we accept, for example, that the states should perform all regulatory and service delivery roles in school education, but that there is a legitimate joint policy role that could be shared

between the national and state governments? If so, it may be possible to achieve a more focused and fruitful discussion about how to properly share that policy role and to put in place more effective controls against 'over-reach'.

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## Focus on roles rather than responsibilities

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To see how this approach might work in practice, following are three examples, one each from an economic, social and environmental portfolio, to which the effectiveness and efficiency tests are applied to determine which layer of government should exercise the respective roles of:

- Service delivery;
- Regulation; and
- Policymaking.

The following examples are illustrations only that oversimplify the detailed consideration required. Each role would need to be examined in more depth, and assumptions properly exposed and tested. It is very unlikely that the 'solution' would be self-evident, even in the less-contested responsibility areas for which there is relatively minimal overlap. But given our nation's experience with increasing centralisation, and the value that arises from federal coordination and cooperation, the outcome would likely have more 'stickability' than one that just hands full responsibility for a portfolio area to one layer of government or the other.

### Example 1: Transport portfolio

*Service delivery* should be managed at state level on both effectiveness and efficiency grounds. It is effective because it ties into city planning and ensures alignment with longer term urban development, and efficient because states are better able to procure and manage transport contracts, and they can develop innovative models for joint ventures and cost recovery.

*Regulation* arguably could be state-based for reasons of relative effectiveness, particularly with respect to intrastate safety and interoperability. But a case could be made, on economy of scale grounds, for a national regulator of interstate transport. This might lead to a conclusion that there be state-based regulation, which would include monitoring compliance with national (not necessarily Commonwealth) standards for interstate transport.

*Policy* functions would be usefully exercised at the state level for efficiency and effectiveness, as this would achieve alignment with regulatory and delivery approaches. However, there would be a strong case for integration with national infrastructure and economic development policies. For that reason, policy functions in transport might be shared, but with a clear division: The states would agree to national standards (thereby avoiding the rail gauge problem) without the Commonwealth, but all nine jurisdictions would coordinate on transport aspects of national infrastructure policy.

### Example 2: Human services portfolio

*Service delivery* would be more effective at the state level given the proximity to the client and opportunity for local tailoring and innovation. However, taking account of the relationship to national income tax and benefits provision via Centrelink, there are efficiency grounds for the Commonwealth to take responsibility. This suggests a shared

delivery role with clear delineations between benefit and voucher provision on the one hand (that is, where financial transactions are the basis), and face-to-face service provision through state-owned or managed agencies on the other hand.

*Regulation* of providers at the national level would be more efficient for services that are universal in nature, but regulation arguably would be more effective at the state level given proximity to the large number of regulatees and the ability to better take account of the local context. We might infer from this a shared regulation role, with clear delineations between regulation of universal entitlements and regulation of contracted service provision for case management or cohort-specific services. Alternatively, there could be national regulation of the latter to ensure distance between the regulator and service deliverer.

*Policy* arguably should be nationally coordinated on both efficiency and effectiveness grounds to enable appropriate intersection between universal services and tailored services. This assumes that universal services are delivered (at least in part) by the Commonwealth, in which case such national coordination should involve the Commonwealth rather than be purely state-based. Conceivably, though not necessarily recommended, the Commonwealth could lead policy development (in consultation with the other jurisdictions), and ‘delegate’ the detail of policy concerning case management or cohort-specific services to the states. To delegate such powers, however, the Commonwealth would first need to explicitly acquire them, that is, constitutionally.

### Example 3: Environment portfolio

*Service delivery* in this context is to ‘the environment’ rather than the public, who as users of the environment are the beneficiaries rather than the prime object of government action. Delivery would need to be a shared enterprise between state and Commonwealth because, while environmental diversity is important and implies localised management on effectiveness grounds, political boundaries are not meaningful. It is efficient, therefore, to think in terms of a national approach to servicing the environment.

*Regulation’s* focus, in considering effectiveness, is on the interaction of different environments (for example, marine and land) and the natural and manmade environments (for example, urban perimeters). This interaction is localised, implying state responsibility for regulation. From an efficiency perspective, when we think about regulating air and water quality, it would be relatively less costly if done nationally. Environmental regulation relating to planning could more efficiently be done, however, at the state or local government level. Together these considerations suggest that states should retain regulatory control but they should regulate against nationally agreed standards to ensure consistency and to maximise efficiency for businesses.

*Policy* would be performed most effectively and efficiently at the national level. If we think of environmental outcomes, we think nationally or even globally. It doesn’t make much sense to think of state environmental outcomes, again because sovereign borders are less meaningful. Moreover, localised environmental issues are often local government rather than state government concerns. Environmental policy therefore should be a national role that sits squarely with the Commonwealth, not least to ensure alignment with international treaty obligations.

### How to deal with shared roles

As the examples show, the efficiency and effectiveness test still produces unclear results – for example, because it might be more efficient for one role to be performed by the Commonwealth but more effective for that same role to be performed by the state.

How is it possible to resolve such tensions?

There are two ways to answer this:

1. The first option is to make a judgement that on balance it is better if the role is performed at one level or the other.
2. The other option is to conclude that the role should be shared.

Making the ‘on balance’ judgement requires tackling the questions of durability and alignment with the spirit of the federation – that is, determining whether there is the national will to sustain the arrangements. In other strong federations, such as Germany, there is a clear understanding that the division and sharing of power between the central and the constituent governments is underpinned by the principle of comity. This apt, if rather archaic, word refers to the idea of harmonious collaboration around a common goal. It is the goodwill and common understanding necessary to uphold the joint commitment to a federation. It is a very relevant concept for Australia’s federal system, but is only implicit in our arrangements. And as one commentator has observed, neglecting the principle of comity “risks an overly legalistic and static view of how federations operate”.<sup>4</sup>

No one can reasonably predict or ascribe the degree of national will to elevate an issue from being one that is effectively managed at the state level, perhaps through coordination among the eight jurisdictions, to one that involves either relinquishing power entirely to the centre, or sharing it. However, it is possible to have a structured negotiation about whether ‘on balance’ a role should be performed solely at one level of government, or exercised jointly.

Broadly, the key questions for the ‘on balance’ discussion take three forms related to three scenarios:

1. If the issue is whether a role should be performed at either the state or the Commonwealth level, the key question is, ‘which result aligns better with our concept of federalism and will therefore prove more sustainable?’
2. If the issue is whether a role should be done in a way that ensures a national approach but it is unclear if that should imply Commonwealth involvement, the key question is, ‘what value is obtained by having the Commonwealth involved – what specifically is brought to the table?’
3. If the issue is that a role should clearly be performed jointly and not just in a coordinated or complementary manner (noting that this is most likely to be a policy role), the key question is, ‘how do we create the right governance to clearly articulate the respective contributions of jurisdictions so that:
  - a) There is no overlap; and
  - b) Appropriate weight is given to the perspectives and input of all those involved in the joint exercise of the role?’

Scenarios 2 and 3 are the most challenging to contemplate because we are so used to the Commonwealth bringing funds to the table. Who would hesitate to say that, in scenario 2, funding equates to a significant ‘value add’ or that, in scenario 3, the Commonwealth shouldn’t have the loudest voice given its underwriting of the

exercise? What is exciting about the white paper process is that governments have a chance to imagine a situation in which funding is not the determinant. Instead, they can consider different types of comparative advantage among the jurisdictions, and where the complementary skills and capacities lie. Doing so enables a case-by-case approach to considering which layer of government (or indeed, which government) should do what within the ‘shared role’ space.

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## Conclusion

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We have a great opportunity to update our federal design. Yet we will only succeed in producing a durable, efficient and effective set of roles and responsibilities if we:

- Think afresh and from a first-principles basis;
- Resist the temptation to fall back on principles that are only half useful; and
- Avoid the habit of starting with the question ‘who is the funder?’

None of this is straightforward. However, agreeing the specific roles that governments perform and defining what ‘comity’ means in Australia’s Federation are useful first steps towards thinking about how power should be divided in our Federation and what governance should be put in place to keep a check on blurred lines or centralising tendencies.

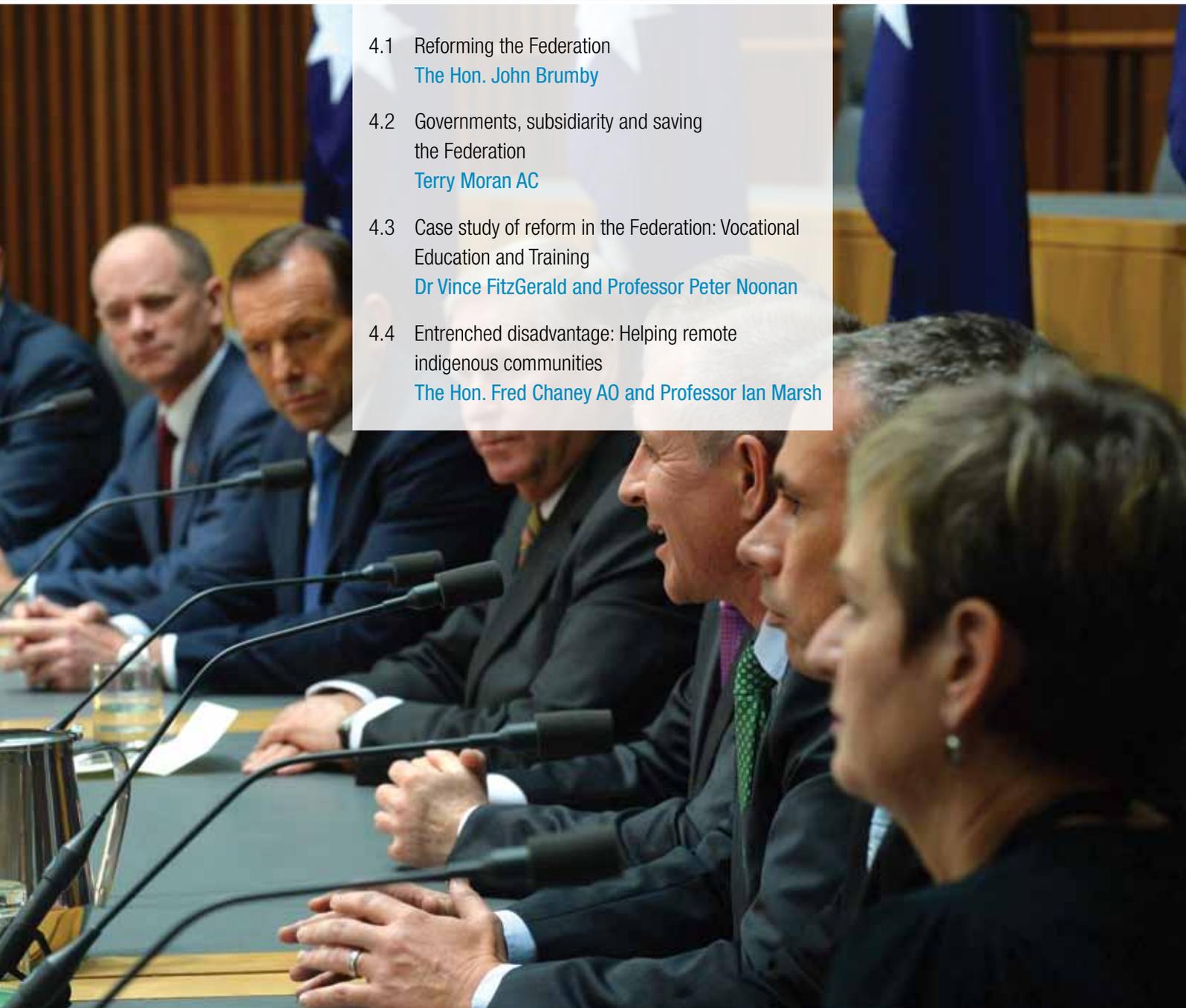
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## Endnotes

- 1 This chapter is based on work that Nous Group has done with clients, and through its own research and experience.
- 2 Elazar 1987, *Exploring federalism*, the University of Alabama Press.
- 3 See for example, Twomey and Withers 2007, *Federalist Paper. Australia’s Federal Future: A report for the Council for the Australian Federation*, Council for the Australian Federation.
- 4 Leanardy 1999, *The Institutional Structures of German Federalism*, accessed at: [library.fes.de/fulltext/bueros/london/00538008.htm](http://library.fes.de/fulltext/bueros/london/00538008.htm)

SECTION  
4.0

# A reform agenda

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# 4.1

## Reforming the Federation

### The Hon. John Brumby



The Hon. John Brumby is a former Premier of Victoria (2007–10) and has immense experience in public life, having served more than 10 years as Treasurer and then Premier of Victoria, six years as Leader of the Victorian Opposition, and seven years as Federal MHR for Bendigo during the period of the Hawke Government.

Since retiring from politics, Mr Brumby has accepted an appointment as a Professorial Fellow at both the University of Melbourne and Monash University. He is also Chairman of the Motor Trades Association of Australia (MTAA) Superannuation Fund, an Independent Director of Huawei Technologies (Australia), a Director of Citywide Solutions, and Chair of the Advisory Board of the National Centre for Workplace Leadership at the University of Melbourne.

Mr Brumby was Chair of the Council of Australian Governments Reform Council from January 2013 until the Council closed on 30 June 2014.

In announcing the Terms of Reference for his government's *White Paper on the Reform of the Federation*, Prime Minister Tony Abbott spoke of the "need to clarify roles and responsibilities so that the states are, as far as possible, sovereign in their own sphere". As a former state premier, I welcome this recognition of the role of the states. At the same time, I strongly sympathise with current state premiers and chief ministers who are now coming to terms with the withdrawal of \$80 billion in proposed funding to the states and territories.

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## Federalism works

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We hear a lot about the supposed drawbacks of federalism. When the recent Commission of Audit report claimed that "the current operation of the Federation poses a fundamental challenge to the delivery of good, responsible government in Australia", many commentators took it as an invitation to throw around words like 'wasteful', 'multifaceted' and 'ineffective shambles' in relation to the federal system itself. This criticism is nothing new. In fact, in 2007, Victoria, along with the other states and territories, commissioned Professors Anne Twomey and Glenn Withers to counter the prevailing negativity about federalism with some reminders about its benefits.<sup>1</sup>

Twomey and Withers pointed out that federalism provides a check on power, dividing and limiting the amount of it that any one government can enjoy. It offers choice and diversity, as citizens can vote for one party at a federal level, and another at a state level. It allows for the customisation of policies to the needs of the people they will affect. After all, a policy that works well in Tasmania may not work as well in Alice Springs. Federalism also allows healthy competition between states. As the first Minister for Innovation in Australia, I can confirm that Victoria's massive efforts in science, technology and innovation were driven in part by our awareness that under Premier Peter Beattie, Queensland was moving in the same direction.

Another benefit of federalism is that it allows creativity. States are forced to innovate to meet their distinctive challenges, and to compete with other states. Successful innovations can then be picked up by other states or by the Commonwealth, while the damage caused by failed policies is limited.

Last but not least, there are great benefits in cooperation. Most important national reforms require the agreement of one or more of the states and territories – often all of them. This means that eight governments will examine a proposed reform carefully and critically. The end result acquires a greater depth of insight as well as greater popular legitimacy.

The framers of our Constitution, of course, had no idea of the challenges we would face today. But in fact they recognised this uncertainty, and gave us a system with both flexibility and resilience built in. As Twomey and Withers put it, "Federalism is regarded as one of the best governmental systems for dealing with the twin pressures produced by globalisation – the upward pressure to deal with some matters at the supra-national level, and the downward pressure to bring government closer to the people".

At this moment in our history, Australia has been a federation for exactly as long as it was a collection of independent colonies. Our model of federalism has served us well. Despite our small population, we are now the world's 12th largest economy, with a median wealth among the highest in the world. We enjoy a stable democracy and a vibrant multicultural society. When much of the rest of the world struggled through the Global Financial Crisis, Australia maintained an economy with low inflation, low interest rates, low unemployment and solid growth.

Our achievements are more than economic. The latest report from the Organisation for Economic Co-operation and Development's *Better Life Initiative* rated Australia above average in 10 of the 11 life dimensions it examined. We are at the top when it comes to governance and civic engagement, and close to the top when it comes to environmental quality and health status. We rate in the top 20 per cent in the areas of housing, personal security, jobs and earnings.<sup>2</sup>

Now, all of this may have been achieved by six self-governing British colonies – but I doubt it. Our Federation has given us a good start in life. Of course no system is perfect, and every system evolves. Australian federalism today differs from the 1901 version in a number of important ways. One of them was spotted by a founding father early on: Alfred Deakin said that the newly minted Constitution left the states “legally free, but financially chained to the chariot wheels of the Commonwealth”. As a former State Treasurer, I can confirm his prescience. Vertical fiscal imbalance is the bane of most federations, and in Australia we have it worse than many. Vertical fiscal imbalance refers to the mismatch between what the various levels of government in Australia are required to do, and the amount of revenue they are able to raise to do it. The states still have primary responsibility for the two biggest costs in the country – health and education – and nowhere near the ability to pay for them. They are indeed ‘chained to the chariot wheels of the Commonwealth’ and, moreover, subject to crippling cuts without warning, as in the last Federal Budget.

Massive cuts to the states was not the best way to start a process of federal reform, but it has precipitated a conversation we need to have about a better alignment of revenue, roles and responsibilities within the Federation, and about how we can work together to meet the challenges we face. It is important to find the right balance. Calls to abolish the states are completely unrealistic, but so is any suggestion that we can turn back the clock.

I believe that the best response to the challenges we face today is one of cooperative federalism: agreement upon objectives, jurisdictional flexibility in working towards those objectives, and strong accountability for commitments made. But we also need to make other changes to the structure and governance of the Council of Australian Governments (COAG) itself.

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## Reforming the COAG

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Attending the COAG over a number of years, I was often reminded that Australia has an advantage over many other federations in that we can fit all our heads of government around one table. Step one towards reforming our Federation today, I believe, is to elevate the status and improve the governance of the COAG. The COAG currently has no real official status. It is run out of the Prime Minister's office, and meets at his or her convenience. This is not where it belongs. After all, the Prime Minister represents just *one* of the parties around the COAG table. The COAG should be an independent body, with an independent secretariat, and a regularised meeting schedule – twice-yearly at first, then moving to quarterly. There should be an agreed forward agenda (no surprises) and the states must have the right to place items on that agenda. This would allow full play to that great benefit of federalism: its responsiveness to local concerns.

Along with a newly elevated status for the COAG must come a dramatic improvement of its governance standards. Over the last decade we've seen enormous improvements in the standards of governance for corporate boards, superannuation funds and not-for-profit organisations. There is no question that this has improved performance. The world is heading in the direction of greater transparency and more rigorous standards of governance. But so far the COAG hasn't evolved in this direction. The Commonwealth and the states must work together on a medium-term strategic agenda to focus priorities. First ministers also need to increase the involvement of ministerial councils, line ministers and line agencies in the COAG process, giving them actual delegated responsibilities and accountabilities for delivering reform. An independent COAG Secretariat could help develop best practice governance standards for what is an extremely important decision-making body.

Further, the chances for effective cooperation at the COAG would be greatly increased by an agreed code of conduct among its members. It is inconceivable that board members of a major company, who are responsible for the interests of tens of thousands of employees and shareholders, would stop on the way to the boardroom to give a 'chest-beating' press conference about their intentions for the meeting. Any government cabinet that behaved in this way would also be seen as dysfunctional indeed. And yet this is precisely what happens before each and every COAG meeting. Given that the decisions taken by the COAG affect many millions of people, meetings should be about policy, not posturing. Just as governments are careful to maintain cabinet solidarity, so the COAG should hold itself to a similar standard.

The recent Commission of Audit called for an emphasis on 'competitive federalism'. As I have noted, a level of healthy competition between states is one of the benefits of a federation. However, we should be careful that we don't end up with *destructive* competition between states, displayed as chest-beating and parochialism, combined with a disdain for collaboration in the national interest. We should also be careful that we do not get into a situation in which we are competing in a 'race to the bottom' of lower taxes, but also lower quality services. And we should be careful that we don't end up with a fragmented patchwork of different rules and regulations that stifle domestic and international trade; a situation in which it might once again be easier, for example, to sell gas across the borders of Europe than across the state borders of Australia.

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## What gets measured, matters

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There is little point in governments cooperating towards agreed goals if no one is tracking progress. Until it was wound up in June this year, I chaired the COAG Reform Council (CRC), which was tasked with monitoring progress towards goals set out in the Intergovernmental Agreement (IGA) of 2008. In this position, I was regularly reminded of the importance and challenges of measurement. To return to the corporate analogy: No successful company would commit enormous amounts of money to an initiative without carefully tracking its progress and impact. COAG agreements involve large investments of taxpayers' money. Performance reporting will therefore continue to be essential, which is why I support the establishment of a new Federation Reform Council, which can independently monitor the timetable, milestones and progress of any new arrangements agreed to as part of the white paper.

Good performance reporting requires two things:

1. High-quality data; and
2. High-quality performance indicators against which it can be measured.

Without the first, of course, the second is useless. While the CRC was recognised internationally as being at the forefront of performance reporting, it is also true that in some areas we struggled with data that was out of date or otherwise not fit for purpose. In other areas, the data simply wasn't there at all. This was sometimes the case, for example, when we tried to report on rural or regional outcomes. Without data, there's no performance reporting. And without performance reporting, there's no accountability.

To get the best from performance reporting, it needs to be outcomes-based. Most stakeholders agree that this is good in principle, but difficult in practice. When you're operating with long timeframes and progress is not closely tracked, it's easy to lose sight of the 'program logic' – that is, the link between inputs, activities, outputs and outcomes. This relates to the previous point about data quality. Without a strong evidence base, governments are tempted to revert to relying on inputs and activities rather than outcomes to measure performance. This in fact happened in some areas under the IGA. The new Federation Reform Council I am proposing would need to make the gathering of high-quality data and outcomes-based reporting a priority.

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## Conclusion: Building the grand bargain

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The Abbott Government's decision to commission the *White Paper on the Reform of the Federation* is timely. But the issue of federal reform is not just one for politicians, academics and opinion leaders. It concerns the whole nation. We need to decide what kind of federation we need to be to become the country we want to be. For this reason, I support a Federation Convention – or perhaps even a series of conventions – to be held this year or the next. This would support the white paper process, and ensure the participation of as many people as possible in what is an extremely important national conversation.

Federation was an enormous achievement won by passionate and idealistic nation-builders. As Elena Douglas wrote, "They saw the nation's promise writ large: a continent as a country; the story of a nation born of a desire for union alone, without bloodshed or tears, here to show the world how it was done. The Federalists saw Australia as a moving new chapter in the human story".<sup>3</sup> The Australian Federation has, I think, lived up to its promise, but any such enterprise requires continual strengthening. A reformed COAG, with stronger standards of governance and accountability, discussed and debated at a national Federation Convention, will set us up well for the future.

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### Endnotes

- 1 Twomey, A and Withers, G 2007, *Australia's Federal Future*, Federalist Paper 1, Council for the Australian Federation, April.
- 2 Organisation for Economic Co-operation and Development, *Better Life Index*, accessed at [www.oecdbetterlifeindex.org](http://www.oecdbetterlifeindex.org).
- 3 Douglas, E 2013, 'What today's politicians can learn from the federalists', *Australian Financial Review*, 9 August.



## 4.2

# Governments, subsidiarity and saving the Federation

## Terry Moran AC



Terry Moran AC has had a varied public service career, working with successive Australian federal and state governments in public policy and public sector management. His early career as a CEO focused on building Australia's education and technical

skills capacity. In 2000, Terry was appointed Secretary of the Department of Premier and Cabinet in Victoria, where he played a leading role in developing an ambitious national reform agenda, subsequently agreed by all states and the Commonwealth Government, and many initiatives to improve planning and service delivery in Victoria.

Terry Moran was Secretary of the Department of the Prime Minister and Cabinet from March 2008 to September 2011, overseeing further development and implementation of this national reform agenda, particularly through social policy. He was also responsible for overseeing work on national security and international policy, environment, industry and economic policy, and coordination of government administration, including Cabinet support. Terry also played a lead role in driving reforms to the public service.

Federation in 1901 is now the middle point between 2014 and arrival of the First Fleet in 1788. Despite this, I suspect that most Australians see federation as being more a creature of the first half of Australia's political existence than our second half. If they have one at all, most views of federation are probably shaped by its 19th Century imagery – dusty, whiskery elderly men in overly formal dress – rather than its 20th Century political and economic outcomes.

This is a shame, because behind the federation process in the 19th Century was the political courage to undertake a radical reform process, in pursuit of the opportunities created by new political and economic structures, as well as broader strategic concerns about Australia's place in the world. Despite being conceived in the 19th Century, federation was a child of the 20th Century, and the challenge for us now is to think of the next stage in its development and the opportunities that a new wave of reforms could create.

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## Past

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Federation has delivered enormous economic benefits to Australia. In an insightful analysis<sup>1</sup>, Professors Anne Twomey and Glenn Withers usefully summarised the benefits that nations receive from an effective federation into what they termed the six Cs:

1. **Checks on power:** An effective federation protects the individual from an overly powerful Government and ensures greater scrutiny of government action.
2. **Choice in voting options:** This ranges from the time-honoured tradition of people voting for one party at the national level and another at the state level, to the choice to move between states – as Victoria found to its cost in the late 1980s.
3. **Customisation of policies:** Federations allow policy customisation to meet the needs of people and communities they directly affect across a large and increasingly diverse nation with substantial differences in climate, geography, demography, culture and income.
4. **Cooperation:** A joint approach to reform is encouraged, which means that proposals tend to be more measured and better scrutinised, and this ultimately gives reform proposals greater legitimacy and potential for bipartisan support.
5. **Competition:** Federations create incentives between states and territories to improve performance, increase efficiency and prevent complacency. In fact, Withers and Twomey actually showed that, despite having an extra layer of government, federations have proportionately fewer public servants and lower public spending than unitary states. This idea is supported by actual change in Australia's public sector employment in which the proportion of the total workforce employed in the entire public sector has declined over 30 years from 25 per cent to 16 per cent.<sup>2</sup>
6. **Creativity:** Successful innovations in one state can be picked up by other states and policy failures avoided. For example, the introduction of Casemix funding, which has revolutionised the funding of hospitals in Australia, began in Victoria in the early 1990s and gradually extended to almost every other state and to the Commonwealth. In 2011, the savings from using the standardised Casemix model of costs was estimated to be around \$4 billion per year, for an estimated annual expenditure of about \$10 million in maintaining the system.<sup>3</sup>

To that list, you could also add Withers and Twomey's assessment that:

7. Federalism increased Australia's prosperity by \$4507 per head in 2006 dollars and this amount could be almost doubled if our federal system was more financially decentralised.<sup>4</sup>
8. Countries with federal systems have tended to outperform unitary states over the last 50 years, even allowing for the intrinsic difficulties in making these sorts of assessments.<sup>5</sup>

It bears reiterating that the cost of government, measured as a share of gross domestic product (GDP), is lower in Australia than in almost all comparable countries.<sup>6</sup> It is therefore also reasonable to suppose that federation is at least partially responsible for successive Australian governments being able to offer relatively high levels of services to its citizens at an internationally competitive cost. Significantly, this cost is lower than in many unitary states, including the United Kingdom and New Zealand, giving the lie to the often asserted idea that state-level government is an intrinsic drag on an economy.

This type of mythology is not just related to the costs of federation. There are also persistent myths about the broader Australian economy. Analysis that delves beyond the superficial layer of political rhetoric shows that contrary to received wisdom:

- The resources sector in Australia has had less impact on the economy than commonly imagined, and consequently its wind down will have less impact;
- The Commonwealth Government currently has a revenue problem more than an expenditure problem; and
- An examination of national savings rates shows that we actually were reasonably effective in saving the proceeds of the resources boom.<sup>7</sup>

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## Present

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My proposals are therefore not based on the failure of our Federation. On the contrary, they are based on the opportunities that could be created by a new practice of government in Australia, occurring within our current political structures.

In my own career, in the senior levels of two state public services and the Commonwealth public service, I have seen the emergence of this new practice of government in both theory and practice. Not by coincidence, this emergence has occurred at the same time as a series of major economic and public sector reforms of the 1980s and 1990s, all of which created a period of unprecedented economic wealth and opportunity in Australia.

One of the most striking aspects of those reforms was the degree to which they were driven through federation processes. Under consecutive Liberal and Labor Party Premiers, Victoria advocated for, and helped drive, successive waves of the National Reform Agenda (NRA). The NRA established broad, measurable, strategic outcomes for state governments. This was the basis for massively simplifying specific purpose payments from Commonwealth governments, which as a result dropped from more than 90 to just six, with states having responsibility and a financial incentive for improving their performance over time. The nation therefore owes Victorian Premiers Jeff Kennett and Steve Bracks, and NSW Premier Nick Greiner, a great debt for their work in pushing the Commonwealth into adopting the NRA. The recent decision to abolish the Council of Australian Governments Reform Council, the body responsible

for monitoring states' progress towards their NRA goals, is therefore a very retrograde step. It means that the states will now legitimately feel that they cannot rely on the Commonwealth as an institution to keep its word.

Central to this new practice of government is the idea of subsidiarity or devolution, in which central governments should perform only those tasks that cannot be more effectively performed at an intermediate or more local level. That idea would of course have been instantly recognisable to those involved in the federation discussions, although probably more from their innate political chauvinism rather than a desire for more efficient public administration.

Not by coincidence, the implications and opportunities of subsidiarity have also become clearer in the last 30 years, as successive waves of economic and public sector reforms have created national wealth and opportunity. But subsidiarity is not necessarily the product of neo-liberal market reforms and there is sometimes equally as much interest in the idea from the community sector as from conservative 'anti-centralists'.<sup>8</sup>

In operation, subsidiarity suggests that we should operate systems with associated political accountability through levels of government where the expertise lies. If state governments operate schools, for example, then they should have the revenue to do that, without confusing the public through multiple levels of accountability. It also suggests that in the human capital area, the Commonwealth should confine itself to high-level regulation, the payment of benefits (such as pensions) and the publication of data on performance (such as *My School*).

In essence, we need to shatter the illusion that the Commonwealth is the 'Swiss army pocketknife' of government in Australia and the current state of aged-care services is a graphic example of the dangers of believing in that illusion.

Conversely, the benefits of taking a subsidiarity approach are now increasingly clear.

As already noted, Casemix funding has substantially reduced growth in the cost of hospital services in Australia. Even the most cursory glance at the United States (US), which uses a market approach to the provision of healthcare services, shows that Australia's healthcare outcomes are achieved at considerably lower cost and with arguably greater social equity. The vast disparity in cost in the US between the same procedures done in different hospitals is well documented,<sup>9</sup> and its economic inefficiency is hard to reconcile with the evangelical view of market efficiency advanced by some in Australia.

In education, in states like Victoria, there has also been a concerted effort to provide school councils and principals with greater autonomy in the operation of public schools. There is still a substantial debate about the exact role of increased autonomy in improving school outcomes, but a recent Victorian Competition and Efficiency Commission report found that what was crucial was the extent to which "local decision making can activate the known drivers of educational improvement, including the quality of teaching and leadership".<sup>10</sup> As a former Director General of Education, I can confirm the veracity of that assertion. It is also hard to believe that increased centralisation is the answer to meeting the diversity of educational needs of 880,000 students across 2200 schools.<sup>11</sup>

It is also noteworthy that many of the reforms developed in Victoria in education and health were closely linked to international thinking from researchers like Osborne and Gaebler,<sup>12</sup> whose work on concepts such as the purchaser/provider split, performance measurement and standardised funding arrangements were deeply influential on the Clinton Administration in the US.

Three further observations support the benefits of subsidiarity as an organisational principle for a federation of the 21st Century:

1. The Productivity Commission's *Blue Book*, which compares the cost of service delivery across state jurisdictions, has shown that in Victoria, where devolution has been a long-term, bipartisan political objective, per capita cost of hospitals<sup>13</sup> and schools<sup>14</sup> has been lower than in most other states.
2. In aiming to improve outcomes for indigenous Australians, which is one of our nation's greatest systemic public policy failures, the greatest opportunities lie in the devolution of decision making and accountability to local communities. Indeed, the success and the challenge of many of the initiatives championed through the Cape York Institute for Policy and Leadership are closely linked to their building of local autonomy, and the ability of local communities to plan and shape service delivery in their local area.
3. It is clear to me that Commonwealth departments have now lost all capacity for effective interventions in large-scale service delivery systems, such as schools and hospitals. Even if there were a popular desire to centralise these services in Canberra, which is hard to believe, there is good reason to believe that this would now substantially damage those services because of this lack of capacity.

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## Future

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This has been the story of the last 30 years. But it is possible to see the stars now aligning to use the subsidiarity principle to crack more of the hardest public policy nuts, including the long-term funding of transport infrastructure, schools and healthcare.

The Grattan Institute's recent series of reports<sup>15</sup> on the long-term budget challenges facing all levels of government describe the increasing unfavourable economic headwinds that the Australian economy will face into the foreseeable future. In particular, they present two unpalatable truths that are evidence of a burning platform requiring a leap towards subsidiarity. First, though not uncontested, increases in Australian government spending are being driven above all by health spending, stemming not from an ageing population but from the fact that people are seeing doctors more often, having more tests and operations, and taking more prescription drugs. Second, claims of a 'massive infrastructure gap' are not borne out by analysis of state and territory budgets, which have spent more on infrastructure in each of the past five years than in any comparable year since the Australian Bureau of Statistics first measured infrastructure spending in the 1980s.

At the national level, we also now have a conservative government that is rooted in a philosophy that has traditionally been sceptical of centralisation. The new tools created by information technology mean that this inclination can now be supported by systems and analysis giving political leaders greater confidence in local-level accountability. In addition, internal government research shows that citizens intrinsically prefer, and rate more favourably, services that are planned and delivered at the local level.

Recent decisions of the High Court suggest that the judicial branch of government is also increasingly sceptical of centralisation. The decision in *Williams No 1*<sup>16</sup> hints that the remedies for judicial dissatisfaction with the Commonwealth Government using executive authority to fund programs may go beyond a simple requirement for debate in Parliament. Professor Anne Twomey has suggested that one of the broader ramifications of the Williams decision may be that the Commonwealth is forced to take a

less ‘coercive’ approach to negotiating with the states in areas such as education funding.<sup>17</sup>

As I have noted elsewhere,<sup>18</sup> it is also the case that our currently centralised system is becoming increasingly sclerotic, in part because of excessive ministerial office interference in service delivery and rapidly oscillating extremes in views about ministerial accountability. One way to improve this situation is to be far more explicit about the division in accountability between ministers and public servants and, as part of that process, by making ministerial advisers accountable in the same ways as public servants. Putting subsidiarity into practice also puts the ‘cookie jar’ of service delivery further out of reach of the hands of ministerial political advisers, who often have no expertise in service delivery, by making the departments they work with more focused on long-term strategy and priority setting.

But the fundamental obstacle to change in our Federation has been one of the world’s most severe cases of vertical fiscal imbalance, which since World War II has been our Federation’s Achilles’ heel. Among other side-effects, it has encouraged state governments to develop what might be called a ‘Willie Sutton’ mentality in which the Commonwealth is seen as the only source of revenue.<sup>19</sup> We need to do better than this as a philosophy for meeting the future needs of funding infrastructure and other essential services. The truth is that the states now prefer to go to the Commonwealth, rather than handle the more challenging task of gaining community support for generating the revenues needed to support the services they provide to the community. To that extent, being shackled to the Commonwealth and its revenue raising capacity is really a matter of choice, not constitutional necessity. As the recent Commission of Audit highlighted, it is now possible to imagine alternative funding systems that would shift this mindset.

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## Proposals

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I therefore conclude by offering five examples of how this could be done in practice and that are predicated on subsidiarity. In implementation, they would meet our growing demands for infrastructure and services, and reinvigorate and reform our Federation for the 21st Century.

First, as suggested by the Commission of Audit, the Commonwealth should walk its own talk on schools by assigning responsibility for schooling to the states and transferring an agreed share of income tax revenues to them for that purpose. This would have the added virtue of cleaning out the programmatic confetti that has traditionally been sprinkled by Commonwealth Ministers across the education sector, to the great detriment of the sector as a whole. There is also considerable merit in the broadly mooted proposal to increase the rate and coverage of the Goods and Services Tax and transferring the extra revenue generated to the states to support growing demands on public hospitals.

Second, state governments should be encouraged to develop a land tax, or property charge, with a broader base of applicability but at a much lower rate than currently applies. Substantial portions of this new revenue stream should be hypothecated to transport improvements, particularly public transport. This would have the added equity advantage of making asset-rich inner-city dwellers draw down some of their windfall gains in property value over time. This is a legitimate policy goal because these gains are, in part, a product of historic infrastructure investments funded from general revenue, especially for the purposes of roads and public transport as well as general urban amenity. At the moment, the only people paying direct, hefty charges for

public infrastructure are the least well off in major cities, struggling to afford a house and land package in outer suburban developments. They pay for marginal extensions to inherited urban infrastructure or tolls on freeways, and a more distributed lower rate property tax could start to redress this inequity.

Third, as cautiously suggested in a report by the Productivity Commission,<sup>20</sup> state governments could extend road-use charging to existing freeways, highways and major arterial roads within cities. This revenue would be hypothecated towards the building and maintenance of these classes of roads and availability-based payments to PPP consortia where needed for new roads. This funding could be further augmented by the fuel taxes collected by the Commonwealth also being hypothecated towards building and maintaining roads. The community is legitimately angry about the idea of paying more for roads, when the original intention was that fuel tax would go towards this function. Transferring most of these tax revenues to the states could be part of an historic settlement to partition government roles in transport in favour of state and local governments, and it would roll back the current process of the Commonwealth second-guessing other governments.

Having each major city pay this combination of property and road charges into their own pool to finance their roads and public transport systems would be a substantial step towards providing the infrastructure needed by our major capital cities. These cities currently generate an enormous percentage of national wealth but their taxes effectively disappear into consolidated revenue at the Commonwealth level. This approach would also provide the resources and legitimacy to fill one of Australia's most pressing gaps in governance: city-wide planning of the sort that was traditionally provided by statutory bodies like the Melbourne and Metropolitan Board of Works.

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## Conclusion

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None of this would be an easy political sell and would need political leadership capable of building a comprehensive political strategy, and a realistic communication plan that would help ordinary citizens understand that strategy. It would, however, play to what should be the strength of politicians: their ability to build alliances towards strategic objectives, rather than as micromanaging CEOs.

It would also have the advantage that devolution is a strategy that, in theory at least, has the capacity to create bipartisan consensus. As the reforms of the 1980s and 1990s show, this is a prerequisite for political acceptance and avoiding rollback by subsequent governments. As the Hon. John Howard remarked recently, successful reform requires the community to accept that it is fair and in the national interest, and a devolution-based argument has a better chance of making that case compared with 'fait accompli' policy proposals suddenly dumped in front of voters.

This would be a major change in Australia's practice of government. It would mean, among other things, a dramatically different role for the public service at the Commonwealth level, one that was focused on providing strategic and technical advice to government and far less involved in service delivery.

In modern terminology it would probably even be called 'disruptive' or 'transformational'. But that is intrinsically what the federation process represented in the 19th Century. It is also striking that some of the core players in this transformation would be the state premiers, the same group who were central to the process that culminated 114 years ago. What we need now is a group of premiers who are interested

in 'saving' the Federation that their political predecessors helped create. They would do this not by transferring more of their power to the centre, but by being the conduit through which more power and accountability flows into the local governance structures that states and local government are best suited to build and support.

For many years, the tide of funding and authorisation within our Federation has flown towards Canberra. As economic headwinds shift, this tide is now turning and business as usual will increasingly struggle to make headway. But as Shakespeare reminds us in his play about political leaders contemplating change, a tide "taken at the flood, leads on to fortune. Omitted, all the voyage of their life is bound in shallows and in miseries".<sup>21</sup>

What we need now is political leadership prepared to ride with that tide.

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## 4.3

# Case study of reform in the Federation: Vocational Education and Training

## Dr Vince FitzGerald and Professor Peter Noonan



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Professor Noonan has played a major role in shaping policy directions in Vocational Education and Training, higher and post-compulsory education in Australia.

Professor Noonan was a member of the Expert Panel for the Review of Australian Higher Education (Bradley Review). He was General Manager and Acting CEO of the Australian National Training Authority (ANTA), and also an adviser and consultant to the Commonwealth Minister for Employment, Education and Training, John Dawkins.

Vocational Education and Training (VET) in Australia is a diverse sector. It has more than 1.9 million enrolments in courses spanning Certificate I–IV programs including apprenticeships, and Diplomas and Advanced Diplomas. These courses are delivered by more than 5000 Registered Training Organisations (RTOs) including public Technical and Further Education (TAFE) institutions, a diverse range of for-profit and not-for-profit non-government providers, schools and major firms. VET has a porous and growing interface with secondary schools at the Certificate level, and with higher education at the Diploma level.

Commonwealth involvement in technical education was limited until the 1970s when it became more involved in supporting the apprenticeship system. Most significantly, from 1974 the Australian Committee on Technical and Further Education (the Kangan Report) laid the basis for significantly increased Commonwealth involvement through the development of a new TAFE system.<sup>1</sup>

VET in Australia is still the formal responsibility of the states and territories. But in the last two decades, a major process of cooperative reform between the Commonwealth and the states has seen VET develop from largely state-based systems of public providers to a more national system underpinned by the concept of a national training market.

This chapter:

- Charts the evolution of those reforms through the process of cooperative federalism;
- Summarises the outcomes of the reforms; and
- Outlines lessons for other areas for which national approaches are required regarding state responsibility for service delivery.

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## Origins and context of national training reform

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By the mid-to-late 1980s, the opening up of the Australian economy to international competition and consequent industry restructuring highlighted the inadequate skills base of the Australian workforce. There was increasing recognition at all levels that the existing arrangements for skills development were not fully meeting the needs of individuals seeking skilled employment or the firms and industries more exposed to the global economy.

In 1987, the Commonwealth Government integrated its functions relating to TAFE (and post-school education and training generally) with its employment and training portfolios. The Commonwealth Minister released major Ministerial Statements signalling a clear intention to ensure that VET more effectively met emerging industry and labour market skills needs.<sup>2</sup> This portfolio integration was progressively implemented in all states and a new national Ministerial Council spanning training and employment was established. At state and national levels, peak industry bodies and industry leaders were given a formal and direct role in shaping decisions on the future of VET.

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## National Training Reform Agenda

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These new portfolio and Ministerial Council arrangements developed what came to be called the National Training Reform Agenda (NTRA). Key elements of the agenda were:

- A decision by the new Ministerial Council in 1989 to replace different state-based training standards and time-based apprenticeships with a new system of national Competency Based Training (CBT) with courses based on these competency standards to be nationally recognised. A joint Commonwealth and state National Training Board (NTB) was established in 1990 to oversee the process of development of competency standards.
- The need for a framework for Australia-wide recognition of training undertaken in any one jurisdiction using these standards was identified. The National Framework for the Recognition of Training (NFROT) was enacted in 1992 as part of a broader mutual recognition agreement covering regulated goods, services and occupations. It was intended to create greater freedom for goods and services providers (and skilled personnel) to engage anywhere in Australia, meaning that registration as a training provider in one state applied in all states.

NFROT provided common standards for the registration of training providers, allowing providers other than TAFE to enter into, and operate in, the emerging VET market. Work also began on an integrated Australian Qualifications Framework (AQF) spanning all sectors of education.

The reform impetus came from both Commonwealth and state officials and ministers. Significantly, individual states took a leading role in the development of specific national reforms including NFROT.

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## A national training market

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The concept of a training market emerged from the broader impetus around the opening up of the Australian economy and key themes of broader public sector reforms – including the separation of the roles of government in funding, policy, regulation and service delivery. This envisaged purchasing services from a wider range of service providers. The concept of a training market was strongly advocated in a 1990 report on the training costs of award restructuring (the Deveson report)<sup>3</sup> to diversify sources of skills supply to meet increasing need and demand.

The concept of a training market – like any market – is an arena in which a related set of services is supplied by providers to users of those services who present their demands (requirements) to a chosen provider. ‘Related’ means either that the services are substitutable for each other *in use* (for example, similar training provided by different organisations), or that there are many providers who can *supply* more than one of them with the same staff and facilities. In the VET context, the providers are training organisations, TAFE institutes and others. The users are the individuals seeking training and the enterprises seeking workforce skills.

To function well, a market must be competitive. There must be rivalry among providers to present the best value for money in terms of quality (broadly defined, including tailoring to users' particular needs and convenience in mode of supply and intrinsic excellence of what is delivered) and price. Users must be able to choose among providers and products to best meet their needs. Effective market operation requires ready availability of information about what is available and its quality.

In parallel with the development of the national training market concept, the Commonwealth and state governments were engaged in major negotiations about the future funding arrangements for VET. The Deveson report also identified significant additional growth requirements for VET. In response, the Commonwealth signalled its willingness to commit additional funding to VET, but it was concerned that if it did so, the states would reduce their investment. This reflected the general problem of cost shifting in areas of shared funding responsibility, exacerbated by the vertical fiscal imbalance in our Federation.

To address the cost-shifting problem, in 1991, the Commonwealth offered to commit substantial growth funding to the VET sector. This was conditional upon the states agreeing to the Commonwealth assuming full responsibility for VET funding offset by adjustment to grants to the states. Although most states gave the proposal serious consideration, it was ultimately rejected. A compromise was reached under which the states agreed to maintain their financial inputs in the first year of a three-year funding agreement and their outputs for the following two years in exchange for substantial additional Commonwealth funding.

The Council of Australian Governments (COAG) also agreed to establish the Australian National Training Authority (ANTA) under Commonwealth legislation to oversee compliance with the funding agreement and to drive the implementation process of the NTRA. ANTA was governed by an industry-based board reporting to a Ministerial Council, with industry-dominated State Training Authorities also established in each jurisdiction.

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## Effective implementation of national training reform

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One of the first things that ANTA set in train in 1993 was a comprehensive review of the national training reforms to assess whether they were delivering what was intended. If not, the review was to determine what the problems were and what should be done to ensure the success of the reforms. The review was commissioned and carried out by a core team of six led by one of the present authors, assisted by 11 others. The report was entitled *Successful Reform: Competitive Skills for Australians and Australian Enterprises*.<sup>4</sup>

The review included extensive consultations with all stakeholders in the national training system. It focused on the extent to which a national training market was developing and whether it was functioning satisfactorily. The review found a number of concerns with the progress of the reforms.

At the heart of these was the way the reforms had been set up and implemented: "... the reforms have been constructed from a supply-side perspective and driven by a top-down policy approach. Efforts directed at demand side issues appear centralist in approach".<sup>5</sup>

The main findings of the review were that:

“The supply of publicly recognised training is heavily focused on courses or parts of courses. This focus is limiting the delivery of the more modular and flexible approach required by enterprises and the emergence of new training products and services. The current concept of the training market is too limited, with many elements necessary for a properly functioning market missing. There is limited knowledge about the match between supply and demand and the market is not accessible to smaller enterprises. Government regulation of and intervention in the market is constricting rather than fostering its development. Consumer information about the price, quality and other attributes of training is missing.”

The report went on to argue that key elements of reform were not working well together. In particular:

- The competency framework added limited value to enterprises;
- National curriculum limited diversity of provider responses;
- Accreditation of courses, recognition of training programs and registration of providers were not well understood or accessible, and they were costly for participants;
- Assessment issues were unresolved; and
- Insufficient attention has been paid to implementation of the National Qualifications Framework.

The review also concluded that “microeconomic reform in the publicly funded vocational education and training sector has been tackled only obliquely”.

The review made 30 recommendations for reform, too many to detail here, but central to them were:

- More effective integration of the key elements of the national training market within a single market facilitation agency through ANTA, including legislation to give effect to NFROT; and
- To shift the focus of the reforms to the demand side, to phase in a major element of ‘user buys’ or ‘user choice’, the power to direct government funding for off-the-job training to a particular provider being placed in the hands of the employer and the employee being trained *jointly*. The context for this was training under a formal, contractual employer/employee arrangement, i.e. an apprenticeship or traineeship, in which there was a strong *mutual* interest between employer and trainee. This would ensure that providers would need to be responsive to the requirements of both those receiving training and those using the resulting skills.

The review also made recommendations to broaden the approach to development and application of competency standards (a recommendation largely overlooked).

Apart from the separation of funding from training provision inherent in its proposals, the review recommended clear definition and separation of roles and responsibilities for policy, strategy, planning and coordination, operational management and market facilitation from the actual delivery of training.

This approach broadly mirrors elements in other public sector and national reforms of that era. Indeed, that clear definition and clear separation of roles must be a fundamental element in any approach to reforming service delivery in areas (such as health) where a *national* approach – that is, one involving both major levels of government – is needed, and indeed in intergovernmental relations generally.

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## Implementation of reforms

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The ANTA Board acted on the review recommendations, gaining agreement from the Ministerial Council to:<sup>6</sup>

- Incorporate functions related to competency standards and national recognition into the ANTA structure through a new standards and curriculum council; and
- Begin the phased introduction of user choice for apprenticeships and traineeships from 1996 based on agreed national principles (including access by providers across the states).

User choice was piloted and then progressively introduced in each jurisdiction, albeit with some jurisdictions excluding some areas of apprenticeship from full contestability.

To establish the provider market, the states and territories established lists of approved providers (RTOs) meeting minimum requirements and delivering courses based on national competency standards leading to an AQF qualification. Funding for providers was based on prices set by each state or territory based on course duration and cost, with fees also regulated. Additional funding could be provided in areas of thin markets, rural and regional provision or to address equity issues. With prices fully regulated by government, price signals between the key participants in the market were, and are, largely absent. Competition was only in terms of quality (very broadly defined, as noted).

A series of state- and territory-based markets developed, with states and territories resisting proposals from ANTA for greater consistency in pricing and access by providers to funding across jurisdictions.

The NFROT guidelines were substantially enhanced, and model legislation developed for, and adopted by, all jurisdictions to underpin mutual recognition of courses and providers.

Subsequent reforms led to the direct alignment of national competency standards with AQF qualifications so that an RTO had scope of registration in a particular industry or occupational sector. State-based course accreditation processes were largely discontinued, meaning that providers were then able to effectively provide across jurisdictions once they were registered in one state – but they were still required to enter into contractual arrangements in each state to deliver government-funded programs.

The review recommendations relating to the establishment of a national training market oversight body were not pursued and ANTA itself was abolished in 2005, with its funding and national policy role resumed by the Commonwealth. Oversight of standards and quality was undertaken through a National Quality Council reporting to the Ministerial Council serviced by an independent secretariat. The secretariat function will now also be absorbed into the Commonwealth Department.

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## Outcomes from reforms

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In terms of the outcomes of these reforms, the key elements of the national training market – provider registration and national competency standards and qualifications – are now central to the architecture of VET in Australia. Those key elements now fall largely under the responsibility of the Commonwealth Government following agreement by most jurisdictions to the establishment of the Australian Standards Quality Agency (ASQA) as the national VET provider regulator (Victoria and Western Australia still register and audit state-based VET providers) and the Commonwealth's assumption of oversight of national VET provider and competency standards.

The move to a national regulator reflected growing recognition that differences in state interpretation of the provider registration standards under mutual recognition was leading to inconsistencies in the application of the standards. This was leading to loss of confidence in quality and outcomes, and major inefficiencies and transaction costs for national providers and companies.

While the central architecture of the national training market has endured, there has been ongoing and strongly contested debate about the adequacy of the provider registration standards (with significantly strengthened standards now pending final approval and implementation) and, similarly, unresolved debate about the adequacy of the current competency standards framework in terms of contemporary learner and workplace needs.

KPMG undertook evaluations of the initial user choice pilots and the full implementation of user choice in 1999.<sup>7</sup> These early evaluations found strong benefits in terms of provider responsiveness and employer influence over provider choice, but with less awareness of user choice by apprentices and trainees. They also foreshadowed concerns about the quality of provision in areas of rapid growth – concerns reflected in subsequent reviews of the quality of traineeships in several jurisdictions.

The KPMG evaluation noted that it is difficult to separate the effect of user choice from other measures, in particular strong marketing of apprenticeships and traineeships, the effect of employer subsidies, reforms to training standards and content, and the generally buoyant labour market conditions that prevailed in Australia until recently.

Since the introduction of user choice, apprenticeship and traineeship numbers have grown strongly; however completion rates, particularly of traineeships, have remained low. Traineeship numbers have been inflated by the extension of traineeships and employers, subsidies to existing workers and to part-time employees, something exploited by some providers. Governments, particularly the Commonwealth, were until recently reluctant to tighten the use of subsidies. But when they did, the rapid decline in traineeship intakes highlighted the extent to which the traineeship market had been inflated by public subsidies.

There has been far less concern about quality and inappropriate provider behaviour in the apprenticeship market, despite substantial growth in that market – with new providers generally being industry-based organisations including group training organisations, and for-profit organisations with strong industry and enterprise relationships. Commitment by existing tradespeople, supervisors and industry leaders to their trades and the apprenticeship system have served as an important internal quality control. Employer and student satisfaction levels with VET programs here have also been relatively high.

Markets in VET, like other markets, appear to operate most effectively when the qualification being provided is valued, where the employer has a strong understanding of the outcomes to be delivered by the qualification, there are reasonable rates of return and the conditions for contracting out of services are met.

Under current state-based funding arrangements, it has not been possible to fully extend the benefits of the architecture of the national training market – national standards, qualifications and provider regulation – to publicly funded VET delivery. National providers and firms must therefore continue to transact different contractual requirements, pricing and even course duration requirements in each jurisdiction. This means that one of the original agreed principles, that there should be a national training market not limited by state boundaries, does not exist in practice.

Notwithstanding these varied experiences, a simple test of the long-term outcomes of user choice is to observe that that term is now rarely used in VET. Employers have become accustomed to selecting their provider of choice. RTOs including TAFEs have embraced the benefits of being able to market directly to enterprises, to leverage other training opportunities with enterprises from their apprenticeship and traineeship relationships, and to partner with other service providers.

Within TAFE institutions, managers have been able to drive internal reforms including setting revenue targets, focusing staff on client relationships and introducing more flexible delivery practices. In short, there would be little or no support for a return to the previous arrangements.

The principle of user choice is now being extended to the new student entitlement model in VET, also agreed by the COAG. Although, indications are that these models will vary significantly between jurisdictions as states and territories seek to limit VET outlays in a constrained fiscal environment.

The other major area of national reform VET funding remains unresolved, with VET funding levels now badly lagging growth in schools and higher education.

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## Implications for reform in service delivery in a federal system

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The process of cooperative reform has transformed Australia's VET system from separate state and territory systems of public VET providers to a national system underpinned by national recognition of standards and qualifications, and national regulation of providers.

The key elements of the national training market – national recognition and national regulation – have not only endured, they have effectively become responsibilities of the Commonwealth, while the funding and operational responsibility for VET has remained with the states. Within the next few years, government funding for VET will be almost fully contestable as the principles that drove user choice are further extended.

The major elements of the national VET system and the training market were developed through an intensive period of cooperative reform between the Commonwealth and the states, driven by both levels of government through policy objectives and decisions of both Ministerial Councils and the COAG.

VET is not the only area of service delivery in which a national approach will better serve the community than separate and different approaches state by state. In health, for example, it is a clear preference of the Australian community that all Australians, wherever they live, should have access to healthcare of at least a given standard, even though delivery and important aspects of policy are best carried out by the states.

Thus, the lessons from the experience of reform in VET may have useful implications for reform in other areas. These lessons include:

- The role of developing and agreeing to the vision for the reforms and their high-level architecture has been undertaken at a national level in the Commonwealth-State Ministerial Council on VET and in the COAG itself.
- Operational management has largely remained with the states. However, where national consistency in areas such as quality, standards and data is required, those functions are best performed by national bodies.
- There are clear benefits in having diverse providers operating in a competitive market – benefits in terms of responsiveness to the needs of individuals and enterprises, and in terms of value for money.
- Markets for delivery of government-funded services must be well designed and effectively regulated. In particular:
  - A strong regulatory and quality-assurance framework must be established to ensure that only providers that meet a rigorous quality standard can participate;
  - The purpose of public subsidies and how they are set must be transparent and linked to policy objectives. Poorly designed subsidies will distort provision and lead to poor-quality outcomes.
- Provider markets must be dynamic but stable. Where scale is likely to be needed to attain best practice efficiency and outcomes, provider numbers, quality and ability of providers to make a reasonable return on investment are matters that governments should be concerned with, as government ultimately bears the risk of provider and market failure.
- The above lesson implies a need for independent monitoring of the operation of the functioning of the market and, if required, market oversight.
- Good information systems and flows are important to allow users of the services to find providers to meet their needs, to access objective information about their performance and to enable government to monitor the market. Data must be consistent and comparable.
- Pricing of subsidy levels and user contributions need to be carefully considered. Three approaches can be considered:
  1. Where there are alternative providers and users have access to good information and bear some significant part of the cost of accessing the services, pricing could be left to normal competitive processes.
  2. Competitive tender processes conducted by a funding body could be used.
  3. Where there are few providers and limited information on which users can base choices, a process to establish efficient prices based on periodically examining the cost structures of best practice providers may be preferred. Such processes are not straightforward to set up, but such a process is used, for example, in hospital funding.

- Service delivery is generally a local activity and is best funded and managed at that level. However, where national markets exist or national skills imperatives must be met, it is desirable that programs and funding operate on a consistent basis across jurisdictions.
- Reform is not a once-for-all matter but an ongoing process in which arrangements are modified in response to changing circumstances and experience. Accordingly, cooperation to monitor, evaluate and adjust the reform framework needs to be ongoing. An independent market oversight body in VET (as recommended in *Successful Reform*) might have hastened overdue assessments of the operation of the training market, particularly from the point of view of individual users and enterprises.

Adopting a national approach to reform and ongoing operation of an area of service delivery will inevitably involve tensions between national consistency and national markets on the one hand, and the principle of subsidiarity (i.e. the principle that roles should rest at the lowest level capable of carrying them out effectively) on the other.

In a federal system, such tensions will arise in any area of joint involvement of the levels of government. These tensions must be resolved in the circumstances of the particular area of service delivery. But they should not be seen as a reason for not pursuing a national approach in which – with a good policy framework, careful design and clear allocation of roles and responsibilities – there are significant benefits for the community.

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**Endnotes**

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## 4.4

# Entrenched disadvantage: Helping remote indigenous communities

## The Hon. Fred Chaney AO and Professor Ian Marsh



Fred Chaney AO was a lawyer before entering the Senate in 1974. He was a member of the Fraser Government, and held the portfolios of Aboriginal Affairs and Social Security. After leaving Parliament in 1993, he was a member and then a Deputy President of the National Native Title Tribunal until 1997. He was an inaugural Co-Chair of Reconciliation Australia in 2001 and continues on the Board. He was Chair of Desert Knowledge Australia from 2005 to 2014.



Professor Ian Marsh is a visiting professor at RegNet, the Australian National University, and at the Australian Innovation Research Centre (AIRC), University of Tasmania. His most recent book, *Democratic Decline and Democratic Renewal: Political Change in Britain, Australia and New Zealand* (Cambridge University Press, 2012), concerns the fractured condition of Australian politics.

In areas of overlapping authority, coordination between the Commonwealth and the states is essential. But this has often proved problematic. To orient and direct the policy system, outcomes must be specified. But can realistic outcomes be specified in advance? Further, how can they be reconciled with continuous improvement? Performance management should encourage learning from experience. In practice, does performance management foster micromanagement and gaming – or rather, does it encourage the exchange of information about success and failure, and hence stimulate improved on-the-ground practice?

Indigenous affairs, because of its complexity, is an ideal site for exploring this design challenge. Indeed, responding to criticisms concerning a plethora of overly centralised and often cross-cutting programs, the Abbott Government has foreshadowed a notable development in its own approach. In place of the existing array of individual programs, it proposes to consolidate spending and to introduce a regional administrative structure. To take account of ‘local’ circumstances and capabilities, it aims to allow service designs to be contextualised. These are welcome initiatives. But many responsibilities will properly remain with state governments. The challenge of coordinating this more decentralised structure with existing state arrangements remains.

This chapter argues that, to match the new approach to its own service delivery, a new approach to the coordination of federal-state activity is also needed. For guidance, we look to the pragmatist or ‘learning by doing’ frameworks that have developed in both the European Union (EU) and the United States (US). These arrangements are consistent with the decentralising ambitions of the Abbott Government. They are consistent with the desire to move prime responsibilities for service design away from the centre to regional or local levels. But coordination with state programs will still be required.

Is it possible to establish agreements about overall outcomes that are also consistent with local responsibility for service design? Is it possible to establish an accountability structure that encourages the exchange of information about successes and failures and that thus nourishes continuous improvement?

Any approach would need to accommodate three not immediately compatible imperatives: local discretion, central accountability and continuous improvement. All three are critical if an effective performance framework is to be introduced. How can this circle be squared?

In proposing a fresh approach, we look first at existing coordination arrangements. Have they led to an improvement of on-the-ground practices? Have they involved goals that can change and develop as experience accumulates? If the answer is negative, is there an alternative? Here we describe arrangements that have developed in the EU to manage similar challenges of policy coordination. Could analogous approaches be applied in an Australian setting?

## Indigenous affairs: A case study of centralised coordination

This section briefly reviews the present Commonwealth-state accountability and performance framework. Has it encouraged continuous improvement? And has it been based on outcomes that are realistic and that can be adapted as experience accumulates?

### Closing the gap target

The most recent major step in coordinating federal and state approaches to indigenous affairs occurred after the 2007 election. The Council of Australian Governments (COAG) was the platform for national policy development. In 2008, the COAG agreed to six ambitious targets to 'close the gap':

1. Close the gap in life expectancy within a generation;
2. Halve the gap in mortality rates for indigenous children aged under five within a decade;
3. Ensure all indigenous four-year olds in remote communities have access to early childhood education within five years;
4. Halve the gap for indigenous students in reading, writing and numeracy within a decade;
5. Halve the gap for indigenous students in Year 12 attainment or equivalent attainment rates by 2020; and
6. Halve the gap in employment outcomes between indigenous and non-indigenous Australians within a decade.

How should the targets be conceptualised?

There would seem to be two options:

1. They could be conceived as the beginning point for a top-down process of policy design, which cascades from the centre, through the states, and down to area and local officers. In this case, they become precise national targets, the achievement for which governments can subsequently be held accountable. This also ensures that leadership in policy design is located at the centre. Regional and local agents are then primarily responsible for implementing these centrally conceived designs.
2. Initial targets may be better conceptualised as the beginning point for a more complex and partially decentralised policy process. In this case, the centre can be expected to set overall directions. But precise service designs are largely left to agents who can adapt outcomes to local contexts. But then these local agents are also accountable for how they exercise their discretions.

### Feasibility of closing the gap

In the events, the 2008 ‘closing the gap’ targets were treated as definitive goals. Governments acted as though fully accountable for their achievement. But a number of responsible authorities also questioned their feasibility. Did this have any impact on the initial or subsequent policy conversation? Were any targets modified or adapted? Did the monitoring and performance management regime build on or embody such reservations in its assessments?

The supporting notes to the various national agreements underline the magnitude of the challenge involved in the targets. For example, the gap in life expectancy was to be closed within 25 years. According to the supporting notes, “This equates to an annual improvement in life expectancy of 0.5 years for males and 0.4 years for females ... Gains of this magnitude have taken around 60 years to achieve in the Australian population as a whole”.<sup>1</sup>

On employment outcomes, Jon Altman has shown that the espoused goals were deeply problematic:

“Research shows that between 1996 and 2006 less than 50,000 new jobs were created for Indigenous Australians. To halve the employment gap by 2016 will require between 71,000 and 106,000 new jobs, an extremely ambitious target given that only about 140,000 indigenous people are currently employed. There are enormous variations in projected indigenous jobs required depending on the region of residence ... The chance of finding mainstream employment in remote Australia is limited owing to geographic isolation.”<sup>2</sup>

In the absence of employment, “closing gaps and ending disadvantage” is a mischievous fiction. Altman notes dryly, “Goals expressed in such statistical terms become somewhat rhetorical and hollow if they are not matched by effective policy action or analysis of the causes of socioeconomic difference, and if such goals do not reflect indigenous aspirations”.<sup>3</sup>

Further evidence of the problematic nature of the basic goals is to be found in other official reports. For example, in discussing schooling, the *Strategic Review of Indigenous Expenditure* notes:

“Even by year three at school (average age eight), a very large gap has been established between the learning outcomes achieved by indigenous and non-indigenous students ... The size of the gap varies widely by jurisdiction and location ... it is widest in the Northern Territory in some remote schools no indigenous students meet national minimum standards.”<sup>4</sup>

In relation to health, the report comments that, “Clearly achieving the COAG targets for indigenous life expectancy will be a major challenge with some commentators already labelling the target ‘aspirational’”.<sup>5</sup> A report, *Aspirations versus reality: closing the gap by 2030* by W Hoy, is cited.<sup>6</sup> In relation to economic participation, the whole burden is referred to the *Indigenous Economic Development Strategy*, which was released in 2012. Independently of the Altman criticism, the *Strategic Review of Indigenous Expenditure* paper notes that to meet the stated target, an extraordinary 100,000 jobs would need to be created over a single decade.

These qualifications had no impact on the framing of the targets or their use in performance assessments. The system exhibited no routine capacity to create a conversation around such qualifications or, if they had merit, to assimilate their implications. Reflecting the highly centralised character of the whole process, the targets rather became central to the performance management process. An elaborate performance management structure was introduced, which took the targets as definitive.

Despite accumulating a substantial body of evidence about outcomes, this performance management regime had no capacity to influence the basic policy and implementation framework. Nor did it have any impact on on-the-ground practice.

The closing the gap targets were embodied in an intergovernmental agreement (*National Indigenous Reform Agreement – Closing the Gap*, 2009) and six National Partnership Agreements (covering remote service delivery, economic participation, health outcomes, early childhood development, remote housing and remote public internet access). Three periodic reports were then introduced to survey progress:

- An annual assessment by the COAG Reform Council (CRC);
- A biennial assessment by the Productivity Commission; and
- An annual report by the Prime Minister.

### The CRC's assessment

The work of the CRC illustrates the problematic nature of such centrally determined outcomes.<sup>7</sup> They became definitive benchmarks for judging whether governments were working effectively or ineffectively. But can they also be adapted in the light of later evidence and experience?

Look at the work of the CRC. Until its very last year, its mandate specifically precluded assessment and review of the basic framework. Its brief was to:

- Provide a comparative analysis of the performance of governments;
- Report on progress under National Partnerships that support the National Agreements;
- Report on the performance of governments under various National Partnerships with reward payments;
- Provide an independent assessment of whether *predetermined performance benchmarks* (our emphasis) have been achieved prior to reward payments being made; and
- Report to the COAG on the aggregate pace of activity across the COAG reform agenda.

Council reports and documents indicate the measures and indicators that were used to judge performance. For example, here are some recent findings:

- Based on trends since 1998, only the Northern Territory is on track to close the gap in death rates by 2013;
- There has been little improvement in indigenous reading and significant increases in indigenous numeracy since 2008 – the only Year 3 reading improvement was driven by gains in WA and Queensland;
- Between 2006 and 2011, the national gap widened in employment, labour force participation and unemployment; and
- Australia is close to the target of enrolling 95 per cent of indigenous four-year olds in remote communities in early childhood education by 2013.

According to a former CRC chair, Paul McClintock, while the Intergovernmental Agreement on Federal Financial relations “is recognised internationally as best practice”, the framework lacks overarching conceptual coherence.<sup>8</sup> In an interview just after his retirement, McClintock was blunt in his criticism of an overly centralised structure: “If you have a federation of sovereign states, trying to run it by sending down missives from Canberra is a really bad way to run a nation ... The whole federal space is as confused as it has ever been. There is real doubt about what is going to happen”.<sup>9</sup>

### The Productivity Commission's assessment

The biennial Productivity Commission report is as elaborate as the CRC assessment. A recent review noted its developing scale.<sup>10</sup> In 1995, the first reporting year, the assessment filled 689 pages and involved 100 indicators in 10 service frameworks. By 2002, it had grown to two volumes, with 300 indicators in 22 service frameworks. In 2011, the service frameworks had increased to 24. The 2011 report, which is the most recent, covered some 750 pages. Results are presented against 12 prime and 37 specific sub-targets. The data is presented in aggregate and state-based terms. Where the data allows, it is also disaggregated according to regional location and gender, among other categories. The report emphasises the extent to which outcomes and circumstances vary by location.

The Productivity Commission's report (like the CRC) also takes the closing the gap targets as definitive. It does not draw on its findings to question their basic feasibility or to suggest how, in the light of experience, policy frameworks might be modified or adapted.

According to the 2011 report:

"There are wide gaps in outcomes between Indigenous and other Australians ... Outcomes have improved in several areas. In those jurisdictions with long term data, the mortality rate for Indigenous people declined by 27 per cent between 1991 and 2009, leading to a narrowing (but not closing) of the gap with non-Indigenous people in those jurisdictions. In particular, Indigenous young child (0–4 years) and infant (0–12 months) mortality rates declined by over 45 per cent between 1991 and 2009 (in the three jurisdictions for which data are available: WA, SA and the NT).

"Nationally, Indigenous home ownership has increased, and Indigenous people are achieving better outcomes in post-secondary education, employment and income. However, outcomes in these areas have also improved for non-Indigenous people, leading to little or no closing of the gaps. In other areas, there has been less progress. There has been little change in literacy and numeracy, most health indicators and housing overcrowding for Indigenous people. Rates of child abuse and neglect substantiations and adult imprisonment have increased for Indigenous people but there has been recent improvement in juvenile detention rates."<sup>11</sup>

The report routinely acknowledges not only the difficulty of defining outcomes but also the problematic nature of the causal structure, which is implicit in the selection of indicators. The report "does not set best practice benchmarks or 'league tables', it is the performance of government as a whole, not agencies and benchmarks that is under scrutiny".<sup>12</sup> The idea of 'government as a whole' is not explained.

Commenting on this broad aspect of the framework, Professor Alan Fenna, director of Curtin University's Institute for Public Policy, observed:

"Translating the complex, contested, qualitative world of public policy into agreed upon and meaningful quantitative indicators is difficult. Ensuring that those indicators are accurately linked to output-outcome causalities that are often unclear is more challenging still. And finally doing that across levels of government in a federal system in a way that will provide learning and increase accountability makes it all a decidedly ambitious if not Herculean task."<sup>13</sup>

McGuire and O'Neill<sup>14</sup> update an official 2010 assessment of the impact on actual outcomes of all this analysis. Their findings are not positive. The official 2010 evaluation<sup>15</sup> had urged a more 'strategic' approach. By this, it meant that the Productivity Commission review should be more than "simply a data collection for the nation". It

proposed more attention to best practice examples and the inclusion of case studies of specific approaches. In their update, McGuire and O'Neill find nothing much has changed. They conclude that “the target audience (for the Productivity Commission report) is the central and line agency managers responsible for budget preparation ... evidence of the influence on processes to improve service delivery is limited”.

### Accountability and performance management framework

The foregoing discussion suggests that the accountability and performance management framework is critical. But the present framework sustains a centralised and top-down approach. An elaborate language and narrative has been created that allows the COAG, the Productivity Commission and the associated federal and state treasury and finance departments to engage each other with seemingly minimal or no effect on actual on-the-ground practices. There is no evidence that this reporting framework itself encourages continuous improvement much less reconciles local discretion with central accountability. This accords with analyses in other systems of similar performance management regimes, which concludes that such targets distort local priorities, force local officials to game the system or induce courses of action that are largely or wholly irrelevant to local contexts and needs.<sup>16</sup>

Is there a design that can square the circle between local discretion, central accountability and continuous improvement? Is there a design that would allow outcomes to be adapted in the light of experience? Here we turn to the differently structured arrangements that have developed in EU.

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## Pragmatist governance in the EU

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Following the extensive privatisation of public utilities, the EU and national authorities faced the new challenge of instituting appropriate accountability and coordination regimes, for example, covering energy, telecommunications and food standards.

A new approach gradually emerged, one that has been deliberately designed to encourage ‘learning by doing’. This pragmatist or experimentalist approach<sup>17</sup> took shape as prescriptive regulation, directives and more legalistic forms were found increasingly ineffective and a source of conflict between Brussels and member states. From the mid-to-late 1990s, the general pattern of governance evolved towards arrangements that emphasised learning and that accorded discretion to states in their pursuit of agreed goals but held them accountable for their use of these discretions.

This approach developed as a response to two fundamental features of the governance challenge. The first concerned available knowledge. The actors were unclear both about their medium-term goals and the most effective way to realise them. The second fundamental feature concerned power. No single actor possessed sufficient authority to impose her will. Even where the Commission had legal power, such as in relation to competition policy, the complexity of local cases pointed to a design that devolved a significant role to national authorities. A similar structure was also desirable in cases like data privacy where the environment was extremely fluid or volatile.

This pragmatist or experimentalist approach emerged serendipitously in the EU quite independently of an analogous development in the US. But in formal terms the two developments share common features. The general features of this pragmatist or experimentalist approach are first described and then applications and impacts are discussed.

Irrespective of its institutional patterns, the basic framework involves four broad functional principles:

“First, framework goals (such as ‘adequate education’ or ‘good water status’) and provisional measures for establishing their achievement are established ... through consultation between the centre and the local units and relevant outside stakeholders ... Second, local units are explicitly given broad discretion to pursue these ends as they see fit ... But third, as a condition of this autonomy, local units must report regularly on their performance and participate in a peer review in which their results are compared with those of other units employing other means to the same general ends. These reviews require the local units to describe and explain their efforts to peers and superiors; to show that they have considered alternatives; and to demonstrate that they are making progress by some jointly acknowledged measure of success, or are making plausible adjustments if not.”<sup>18</sup>

The centre provides services and inducements that facilitate this disciplined comparison of local performances and mutual learning.

The objectives that are introduced to guide the development of the overall policy system are not (as in the closing the gap case) prescriptive. Rather, the initial goals are provisional and corrigible – they evolve as experience accumulates. According to Sabel et al, “a large fraction of the norms are indicative or presumptive rather than mandatory ... rules will be continuously revised in the course of application ... (Moreover) rule departures (are treated) diagnostically as symptoms of systemic problems and opportunities for systemic improvement”.<sup>19</sup>

Incentive designs reinforce these outcomes. Their distinctive goal is “to induce actors to engage in investigation, information sharing and deliberation about problems with multiple dimensions that are only dimly understood”. For example, grant programs in the US “award large grants ... through a competitive process in which ... applications are judged on the extent to which they demonstrate capacities to plan and self-assess, to share and make use of information about their own and peer performances, and to coordinate with critical stakeholders in both the public and private spheres”.<sup>20</sup>

This focus on both substantive and process outcomes reflects uncertainty about how broad goals are to be achieved. It builds in incentives to discuss the means by which agents propose to achieve the agreed outcomes. The uncertainty around means suggests the merit of making this conversation explicit. Thus the accountability and performance management system focuses on the potential of different processes or approaches to deliver more effective outcomes. “(Agents) often have discretion to depart from rules when they believe it would be counterproductive to follow them. This discretion, however, is limited by the requirement that this is done transparently in a manner that triggers review, and, if her judgment is sustained (leads to a) prompt rewriting of the rule to reflect the new understanding.”<sup>21</sup>

In translating these general principles to the EU, Sabel and Zeitlin<sup>22</sup> note some of the distinctive features that have emerged:

1. The application of these general principles has occurred through a variety of institutional arrangements such as fora, networked agencies and councils of regulators. There is no ‘one best design’ for the performance management regime. In keeping with the pragmatist spirit of the design, organisational arrangements should reflect contexts, including the standing of the relevant actors, the political imperatives to which they must respond and the general state of knowledge in the relevant policy space.

2. The reporting arrangements can be designed to make a number of contributions to continuous improvement. For example, through its overall mandate and consultation and reporting arrangements, a peer review exercise could achieve a variety of performance impacts:

“A single institutional mechanism, such as a formal peer review exercise, can perform a number of distinct governance functions, such as assessing the comparative effectiveness of different national and sub-national implementation approaches, opening up opportunities for civil society actors to hold governments accountable at national and EU levels, identifying areas where new forms of national or transnational capacity building are required, and/or contributing to the redefinition of common policy objectives.”<sup>23</sup>

3. The voluntary and informal character of these arrangements mean they can work beneath or around purely legal ambiguities or opacities. “The process of socialisation and the consensus that it generates is ... largely informal, in the sense that it was neither directly anticipated by, nor much less can it be deduced from, the directives and other legal instruments establishing various regulatory decision-making processes.”<sup>24</sup>
4. A fourth feature relates to the learning that results from the exchange of experience and the mutual accommodation that it encourages. “Practices and institutions are expected to become mutually responsive but not to converge to a single and definitive best practice.” Indeed, this approach “is especially well suited to heterogenous settings such as the EU, where local units face similar problems, and can learn much from their separate efforts to solve them even though particular solutions will rarely be generalisable in any straight-forward way”.<sup>25</sup>
5. Finally, the experimental framework has its own inducements to compliance. This involves a more subtle set of incentives than directly prescriptive and punitive regimes. These are based on a structure that involves repeated interaction, which can incline the parties towards accommodation. In practice, the risk to present reputation and the potential damage to future interactions can both encourage moderation. The reporting framework can also be designed to encourage a conversation through which the participants come to recognise plausible and superior alternatives to their current practice. Moreover, the focus of the regulatory forums can shift from rules to frameworks for creating rules. “For example, where national authorities disagree with the European Food Safety Authority both parties are obliged to make their arguments and their expert advice transparent.” Similarly, in the case of competition policy, the Commission can intervene in national cases but must formally justify its decision to others in the network. Moreover, “this right of challenge extends horizontally as well as vertically since any member of the network can demand a review of another national competition authority’s handling of the case”.<sup>26</sup>

The federated character of the overall system also builds in strong disincentives to non-participation. This arises from the resources that the central authority can use to discipline persistent recalcitrance. Thus, the Florence Electricity Forum coordinates the EU-wide electricity regime. In cases of disagreement on the part of national authorities, the Commission “has periodically threatened to invoke its formal powers under EU merger, anti-trust and state aid rules whose application would make the intransigent or obstructionist parties worse off than a compromise reached at the Forum”.<sup>27</sup> Ultimately, the Commission can try to deploy its funding or legal authorities. But in practice, this has been infrequent.

In sum, the EU has created a structure that seeks to reconcile continuous improvement in performance, local discretion in service or regulatory design and ongoing central accountability. How relevant might such arrangements be to Australia?

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## Conclusion

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The basic challenges that have been addressed through these pragmatist processes in the EU involve conditions that parallel those in Australia. Take the indigenous affairs case again. There is uncertainty not only in defining realistic outcomes but also in determining the means by which these outcomes can be sought. Moreover, arrangements are needed that can connect sovereign entities and facilitate their mutual learning. The EU design reconciles these elements.

Despite extensive discussion of federal arrangements in Australia, there has hitherto been no attention to the potential of the pragmatist arrangements outlined here.<sup>28</sup> This alternative surely deserves consideration. Of course, assessment requires more analysis than has been possible here. And any implementation arrangements would need to assimilate outcomes from a variety of regions and jurisdictions as well as meeting political needs for national reporting.

On the other hand, the evidence concerning the impact of present arrangements in Australia seems clear. An elaborate apparatus has been set up. This creates an appearance of effective governmental leadership and control. But the targets that have been adopted (albeit with generous intent) seem problematic. And the elaborated performance assessment framework seems largely disconnected from on-the-ground practice.

The EU alternative is based on three elements:

1. Initial, centrally determined outcomes that are provisional and corrigible;
2. Local agents that enjoy discretion in implementing these outcomes; and
3. The condition for this discretion is accountability for its use.

With a new regime to manage indigenous policy emerging at the federal level, it would also seem opportune to recast the federal-state framework. This Chapter has explored a design that is congruent with the decentralising aspirations of the Abbott Government, indeed one that might have much wider application in the general field of federal-state relations.

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 "What we don't know:  
 1. How to significantly increase the early childhood Indigenous work force; to train and support Indigenous workers who will remain in their communities; and to build structures to enable Indigenous workers to develop a career path.  
 2. How to develop unique Indigenous services for Indigenous families rather than rely on models developed for and tested with non-Indigenous groups.  
 3. How to increase trust of Indigenous families in mainstream services and non-Indigenous staff.  
 4. How to best deliver programs to Indigenous organisations and their children in the various Australian contexts, including across geography and sub-cultures.  
 5. How to create the funding and management structures to operate truly integrated services" – Sims, M, *Resource Sheet No. 7*, May 2011.
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Export Finance and Insurance Corporation	Thorn Group
Four Seasons Hotel Sydney	Transport NSW
Future Fund	University of New South Wales
GHD	University of Sydney Business School
Gilbert + Tobin	University of Technology Sydney
Healthdirect Australia	University of Western Sydney
Henry Davis York	WorkCover NSW
Holcim (Australia)	
Hunter Water Corporation	<b>QLD</b>
InfraSol Group	Accenture Australia
Insurance Australia Group	Arrow Energy
JP Morgan	AustralianSuper
JBA	Bank of Queensland
Kreab Gavin Anderson	Bond University
Leighton Contractors	Civil Contractors Federation
Leighton Holdings	Community Services Industry Alliance
Macquarie Group	ConocoPhillips
Maddocks	Echo Entertainment Group
Malcolm Naylor	Energex
ManpowerGroup Australia	Ergon Energy
Marsh	FA Pidgeon & Son
National Insurance Brokers Association of Australia	Gadens
NICTA	Ipswich City Council
NSW Department of Planning and Environment	James Cook University
NSW Environment Protection Authority	KDR Gold Coast
NSW Ports	Leighton Contractors
NSW Treasury Corporation	Leyshon
Parramatta City Council	Local Government Association of Queensland

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Morgans	SA Department of Further Education, Employment, Science and Technology
New Hope Group	SA Power Networks
Port of Brisbane	Santos
Puma Energy	South Australian Water Corporation
QGC	University of South Australia
QIC	Workskil
Queensland Competition Authority	
Queensland Department of Natural Resources and Mines	..... <b>TAS</b> .....
Queensland Department of State Development, Infrastructure and Planning	Aurora Energy
Queensland Department of Transport and Main Roads	Hydro Tasmania
Queensland Law Society	Nekon
Queensland Motorways	Tasmanian Department of Premier and Cabinet
Queensland Resources Council	Tasmanian Department of State Growth
Queensland Treasury and Trade	TasNetworks
Queensland Treasury Corporation	..... <b>VIC</b> .....
Queensland University of Technology	Australian Catholic University
Robert Walters	Australian Institute of Management
Santoro Consulting	Australian Unity
Santos GLNG Project	Bank of Tokyo-Mitsubishi
Sue Boyce	Barwon Water
SunWater	BASF Australia
TechnologyOne	Benetas
Toowoomba and Surat Basin Enterprise	Cabrini Health
UniQuest	CBP Lawyers
University of Southern Queensland	City of Melbourne
Wingate Properties	Clean Energy Council
..... <b>SA</b> .....	CSL
Adelaide Airport	Deakin University
BDO	ExxonMobil
Bedford Group	Future Fund
Coopers Brewery	GHD
	Gilbert + Tobin

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Independent Schools Victoria	ATCO
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Jo Fisher Executive	Chevron Australia
Linking Melbourne Authority	CITIC Pacific Mining
Medibank	City of Greater Geraldton
Monash University	City of Perth
Monsanto	City of South Perth
National Australia Bank	Clifford Chance
NHP Electrical Engineering Products	ConocoPhillips
Open Universities Australia	Curtin University
Oracle	Edith Cowan University
PGA Group	Georgiou Group
Pitcher Partners	Horizon Power
Port of Hastings Development Authority	Jackson McDonald
Public Transport Victoria	K&L Gates
PwC Australia	King & Wood Mallesons
REA Group	LandCorp
RMIT University	Main Roads Western Australia
Ross Paton	Murdoch University
Royal Australian College of General Practitioners	Pilbara Development Commission
Royal Automobile Club of Victoria	Public Sector Commission
Sustainability Victoria	SAP Australia
Telstra	Terry Grose
Thiess	The Chamber of Minerals and Energy of Western Australia
Toyota	Toro Energy
Transdev	University of Western Australia
United Energy and Multinet Gas	WA Department of Agriculture and Food
University of Melbourne	WA Department of Commerce
Victorian Department of Education and Early Childhood Development	WA Department of Regional Development
Victorian Department of Premier and Cabinet	WA Department of Treasury
Western Water	WA Treasury Corporation
Wilson Transformer Company	Water Corporation
	Wesfarmers
	Whelans Australia
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