Australian Government
Productivity Commission

Productive Reform in a Federal System

Roundtable Proceedings

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The Productivity Commission

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Foreword

The Productivity Commission convened a roundtable on the topic *Productive Reform in a Federal System* at Old Parliament House, Canberra on 27 and 28 October 2005. The invitees included senior government officials, consultants, academics, and representatives from industry and community groups.

Reflecting the need to build on past reforms, the roundtable focused on issues associated with the challenge of securing better policy outcomes from our federal system of government. Participants initially examined some generic issues associated with federal systems and their operation in principle and practice. The roundtable then explored opportunities for improving outcomes in the key areas of health, the labour market and freight transport. The final session harvested ideas about ways forward.

As it turned out, the roundtable came at an opportune time during the efforts of senior government officials to develop a reform agenda for consideration by CoAG. The agreement finally reached by CoAG on 10 February 2006 was as wide-ranging and ambitious as many at the roundtable had hoped for. That said, much remains to be done to translate that agreement into practical reforms.

This publication has been prepared to enable wider dissemination and consideration of the ideas and insights that emerged from the roundtable. It includes the papers prepared by the speakers as well as the responses of the discussants and panellists and summaries of the general discussion sessions. Also included is an overview covering the key points raised by the speakers and other participants. The Commission remains grateful for the constructive contributions of all those who participated in the roundtable, the value of which is evident in this volume.

Gary Banks

Chairman

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Acknowledgments

The Commission extends its thanks to everyone who participated in the roundtable. Special thanks go to the speakers and authors of the main papers — Peter Anderson, Vince FitzGerald, Ken Henry, Barry Moore, Jonathan Pincus, Andrew Podger, Rod Sims, Andrew Stewart, Cliff Walsh and Tony Wilson — and the discussants — Stephen Duckett, Henry Ergas, John Freebairn and Ross Garnaut. The contributions of the panellists — Geoffrey Brennan, Paul Kelly, John Langoulant and John Roskam — are also gratefully acknowledged.

Ian Monday, Jonathan Pincus and Gary Samuels from the Productivity Commission had primary carriage for organising the roundtable and contributed greatly to its success. This volume of proceedings was prepared by Ian Bickerdyke, Rosalie McLachlan and Joanna Abhayaratna under the direction of Ian Monday. Roberta Bausch provided valuable administrative support. The Commission is grateful to them all.

Abbreviations

ACAT	Aged Care Assessment Team
ACCC	Australian Competition and Consumer Commission
ACCI	Australian Chamber of Commerce and Industry
ACSQHC	Australian Council for Safety and Quality in Health Care
ACTU	Australian Council of Trade Unions
ADRs	Australian Design Rules
AHC	Australian Health Commission
AHCAs	Australian Health Care Agreements
AIHW	Australian Institute of Health and Welfare
AIPC	Australian Institute for Primary Care
AIRC	Australian Industrial Relations Commission
ATC	Australian Transport Council
ARTC	Australian Rail Track Corporation
AWAs	Australian Workplace Agreements
AWU	Australian Workers Union
BCA	Business Council of Australia
BTE	Bureau of Transport Economics
BTRE	Bureau of Transport and Regional Economics
CoAG	Council of Australian Governments
DHA	Department of Health and Ageing
DHAC	Department of Health and Aged Care
DOTARS	Department of Transport and Regional Services
DORC	Depreciated Optimised Replacement Cost
GP	General practitioner
GDP	Gross domestic product
EU	European Union

HACC	Home and Community Care
HFE	Horizontal fiscal equalisation
IAC	Industries Assistance Commission
IC	Industry Commission
IGAs	Inter-Governmental Agreements
ISC	Inter-State Commission
MBS	Medicare Benefits Schedule
NCA	National Commission of Audit
NCC	National Competition Council
NCP	National Competition Policy
NHS	National Health Service
NRTC	National Road Transport Commission
NTC	National Transport Commission
OHS	Occupational Health and Safely
PBS	Performance-based standards
PBS	Pharmaceutical Benefits Scheme
PC	Productivity Commission
PHI	Private Health Insurance
RHA	Regional Health Agencies
RIS	Regulatory Impact Statement
R&D	Research and development
SCRGSP	Steering Committee for the Review of Government Service Provision
SPP	Special purpose payment
WHO	World Health Organization
VFI	Vertical fiscal imbalance

Overview

Australia's federal arrangements significantly influence many areas of public policy and its implementation. Accordingly, the current state of federalism and the scope for improving the operation of Australia's federation have been prominent and, at times, controversial topics of debate.

As Gary Banks observed in opening the roundtable, federal systems of government have some important strengths and can be conducive to beneficial policy innovation over time. They also can give rise to inefficiencies and coordination failures, such as when functions are not well allocated or where governance arrangements relating to them are not well designed. Since our federal system is here to stay for the foreseeable future, the important thing is to get the best out of it.

The Commission organised this roundtable to provide an opportunity for key issues bearing on national reform to be discussed in the lead-up to a Council of Australian Governments (CoAG) meeting in February 2006 to seek agreement on a post-National Competition Policy (NCP) reform agenda.

This overview brings together the main points raised by speakers, discussants and participants. It is organised around three sections:

- getting the best out of our federal system — design issues associated with the effective operation of federal systems;
- case studies covering health, the labour market and freight transport; and
- the way forward.

Getting the best out of our federal system

Jonathan Pincus and Cliff Walsh were the speakers for the first session of the roundtable. Pincus, in presenting the Productivity Commission's overview of the issues (from its 2004-05 Annual Report, PC 2005a), pointed out that, as a federation, Australia is in good company — about 25 of the world's 193 countries have federal systems of governance, accounting for about 40 per cent of the world's population and about 50 per cent of global GDP.

In its 2004-05 Annual Report, the Commission summarised the potential advantages and disadvantages of federalism (box 1). It also noted that Australia's federation has a number of distinctive features — a relatively high degree of shared functions between governments, a strong centralising trend over time, a relatively high degree of vertical fiscal imbalance (and transfers directed at fiscal equalisation) and innovative initiatives in cooperative federalism.

Box 1 **Advantages and disadvantages of federations**

Potential *advantages*:

- dispersing power across jurisdictions to encourage more responsive government;
- allowing for diversity in the provision of sub-national goods and services in response to voter preferences, while facilitating the provision of common goods and services by a central government;
- enhancing the competitive pressure on governments to respond to the preferences of citizens in their jurisdictions; and
- creating opportunities for interjurisdictional learning from different policy approaches.

Potential *disadvantages*:

- higher transaction costs from diversity and fragmentation in rules and regulations;
- scope for 'destructive' interjurisdictional competition; and
- inefficiencies that arise when functions are not well allocated or where governance arrangements relating to them are poorly designed.

Source: PC (2005a).

A useful way of thinking about the challenges in getting the best out of our federal system is in terms of exploiting opportunities for both 'competitive' and 'cooperative' federalism, while minimising the risks of destructive competition and coordination failure.

The competitive dimension of federalism

Pincus noted the Commission's assessment that, by and large, the competitive dimension of federalism in Australia is operating well and provides in-built incentives for governments to perform better. He said that competitive federalism to date had provided significant benefits — for example, through direct competition between the Australian and State Governments, through yardstick competition between the States and by encouraging the States to get the 'economic fundamentals' right. But, even so, competition between the States can be

destructive, as can occur with interstate bidding wars to attract major projects, and through some forms of tax competition.

It was observed that the design and operation of Australia's intergovernmental transfers to address the vertical fiscal imbalance created by the assignment of taxation and expenditure powers has given rise to some concerns. These include the potential for distortions to the process of horizontal competition and the scope for gaming under the equalisation process used by the Commonwealth Grants Commission to determine grants to the States.

Cliff Walsh emphasised the benefits of competitive federalism, claiming that it should be 'harnessed, not suppressed'. According to Walsh, 'for the most part, political competition in federal systems is more welfare-enhancing than any conceivable alternative'. In his view, competitive intergovernmental relations are not inherently a source of waste and inefficiency as they do not block coordination and cooperation where it is mutually beneficial. Further, he argued that overlap and duplication may be a sign of the system functioning relatively well.

Walsh acknowledged that competitive federalism may not always produce the best feasible outcomes. But, he argued that this needed to be established on a case-by-case basis.

Ross Garnaut, the discussant, acknowledged that vertical and horizontal competition within federations could be beneficial in some circumstances, but damaging in others. Even so, he claimed that it can be difficult to assess outcomes of competition when at the centre of federal-state relations there are huge transfers based on principles that 'probably only a dozen people in Australia outside government understand'. And, while yardstick competition should be about whether one State does a better job of equating the costs of raising taxation with the benefits of expanding public services, 'that margin depends on whether a State is a donor to the equalisation system or a recipient of it'.

Ken Henry, speaking at the roundtable dinner, questioned whether the plethora of inconsistent State-based regulatory requirements in areas such as occupational licensing, occupational health and safety, road transport and water trading — could be attributed to competitive federalism. One of the examples he provided was an operator of an interstate train having to 'deal with six access regulators, seven rail safety regulators with nine different pieces of legislation, three transport accident investigators, 15 pieces of legislation covering occupational health and safety of rail operations, and 75 pieces of legislation with powers over environmental management'. He also noted that Australia has seven rail safety regulators for a population of around 20 million people whereas the United States, with a population of 285 million, has only one.

Henry acknowledged that, while such arrangements could possibly be explained by competitive federalism, the more likely explanation is 'a stubborn parochial interest in putting the welfare of the State or Territory ahead of that of the nation'. And, while parochialism is understandable, 'a proper accounting of its national economic consequences would be weighted heavily in the negative'.

Box 2 **Some participants on competitive federalism**

- John Roskam: 'Competition is seldom 'wasteful'; the existence of 'waste' must be matched against the benefits of choice and diversity'.
- John Langoulant: 'Competitive federalism clearly does have a role to play … the most beneficial role is through yardstick competition'.
- Vince FitzGerald: [commenting on yardstick competition] '… that sort of rivalry, the kind of competition, on a yardstick basis, the more the better … have the public informed about how your State compares with the others and the fact that it's not doing as well should make people jump up and down'.

The cooperative dimension of federalism

Commenting on the cooperative dimension of federalism, Pincus referred to the Commission's identification in its annual report of an extensive and varied array of intergovernmental cooperative arrangements (including mutual recognition schemes, harmonisation schemes and national standards) that had developed under the Australian Federation. In the Commission's view, these have facilitated a fundamental reshaping of economic policy making in several key areas.

Collective and cooperative action will be especially important in responding to future challenges — such as globalisation, environmental sustainability and population ageing — because of the extensive cross-jurisdictional elements associated with each challenge. The Commission has highlighted the need for national coordination in a number of key reform areas, including health, the environment and freight transport, and has emphasised the strong leadership role required from CoAG.

While Walsh acknowledged that a greater degree of cooperation is desirable, and in the national interest in some areas of intergovernmental and interjurisdictional relations, he maintained that competition, not cooperation, was the preferred organising principle for federal relationships. In his view, a substantial degree of cooperation will exist even in intensely competitive intergovernmental and interjurisdictional relationships.

Garnaut agreed that Australia had shown that it could overcome some of the damaging features of its federal arrangements through cooperation. He suggested that the one point of optimism that could be agreed on was that it is possible to get better welfare-increasing outcomes through cooperation. But, he also maintained that a large effort was required to develop and apply effective institutional arrangements.

Box 3 **Some participants on cooperative federalism**

- John Langoulant: 'I am a strong believer in cooperative federalism. I think it is through cooperative approaches that you get stronger and more enduring outcomes'.
- Ken Henry: 'Competitive federalism may be contrasted with cooperative federalism. Looking back over the whole period since federation, one would have to conclude that cooperative federalism is much the weaker of the two — characterised by only irregular and infrequent bursts of activity'.
- Vince FitzGerald: 'It is essential that all the States and the Australian Government be involved in the design of the framework for an integrated health care system'.
- Andrew Stewart: '...the only sensible way to achieve a national system [of workplace relations] is through federal-state cooperation, just as has happened in other areas such as corporate governance'.
- Rod Sims: 'A well structured and coordinated process of change between Australian and State Governments is required. This is clear from looking at how past major transport reforms have been achieved, and from examining the required future reform agenda'.
- Tony Wilson and Barry Moore: '…the majority of [land transport] reforms need to be addressed through a cooperative approach to federalism in order to achieve an effective national outcome'.

Garnaut also suggested that there are limits to the optimism one can have about reform in Australia without fundamental change in the fiscal heart of federal-state relations. He said that there is hardly a single function of State Government that does not receive some special purpose payment (SPP), with conditions applied, from the Australian Government and that this creates an opportunity for sectoral agencies in the Australian and State Governments to collude against reform.

In the general discussion session, there was some debate about whether Australia's fiscal relations system removed or weakened the incentive for State Governments to pursue reform. One participant argued that federal-state fiscal arrangements remove one of the big drivers of reform. Other participants, however, noted that there are fiscal dividends to the State (and Australian) Government treasuries through the GST. Also, benefits to the States from undertaking reform in the form of economic

and social dividends can be more important than fiscal dividends. Another participant argued that any serious reform initiatives in this area would need to look at SPPs, because in areas such as health, aged care and community services, they are 'essentially the constitutional machinery which is depriving States of any room for competition'.

Case studies of key reform areas

The case study sessions provided an opportunity to examine how Australia's federal system works in practice — in the important areas of health, industrial relations and freight transport — and to explore ways in which we could get more out of our federal system in these areas. In all three case studies, problems were identified stemming from the division of policy responsibilities between the Australian and State and Territory Governments. Also common to the three case studies were debates about the appropriate jurisdictional roles and about responsibilities and the most effective intergovernmental arrangements for managing reform.

Health

Vince FitzGerald and Andrew Podger both noted that Australians enjoy relatively good health and that our health care system performs well compared with those of other countries. However, they also identified significant problems with the health system (box 4). A key area of concern was the current division of responsibilities between the Australian and State Governments.

- Podger said that each of the problems with Australia's health system that he identified was exacerbated by the division of roles and responsibilities between the Australian Government and the States. This led him to a consideration of options for systemic change in the current division of roles and responsibilities.
- FitzGerald claimed that the complex split in responsibilities for funding and provision of health care leads to poor coordination of planning and service delivery, barriers to efficient substitution of alternative types and sources of care, and cost shifting.

Box 4 **Problems identified with the current health system**

Among the problems with the current health system identified by speakers at the roundtable were:

- cost shifting between governments; for example, public hospitals (State funded) referring patients being discharged to their general practitioner (Australian Government subsidised); and shortages of aged care places (Australian Government subsidised) resulting in hospital beds (State) being inappropriately occupied;
- funding and delivery arrangements which create barriers to continuity of care and good planning;
- access arrangements which differ for public and private hospitals;
- a complex interface between the public hospital sector and aged care sector;
- allocative inefficiency and poor use of competition;
- health workforce issues, including the lack of effective formal structural links between the health and education sectors; and
- poor use of information and communication technologies.

While identifying similar problems with the functioning of the health system, the solutions proposed by Podger and FitzGerald differed in significant ways.

Podger's options for systemic change all involve moves towards a single funder and/or single purchaser:

- States having full responsibility for purchasing all health and aged care services;
- the Australian Government taking full responsibility as funder and purchaser;
- federal-state pooling of funds; and
- managed competition.

Podger favoured the Australian Government assuming full financial responsibility. He recognised that this would involve costs, risks and a lengthy transition, but considered it to be feasible. He also suggested that, for this option to be successful, a range of complementary measures would first need to be undertaken.

FitzGerald argued that while it was necessary to have a consistent national framework, the way in which health care is organised and delivered should vary across States to suit local circumstances and local community priorities. Indeed, a strength of federal systems is the diversity they allow which is most conducive to policy innovation and service improvement. He maintained that a complete redesign of the current system involving the integration of Australian and State Government

health care programs through funds-pooling and budget holding — implemented to suit each State's circumstances — was necessary if the underlying problems were to be effectively addressed.

FitzGerald acknowledged, however, that in practice such a redesign would be 'complex, difficult and time-consuming'. It would also require a great deal of collaboration among the Australian and State Governments in respect to governance systems, organisational and workforce development, as well as considerable institutional effort to support change. He argued the case for beginning the move towards an integrated system, with reform to primary health care. He suggested that each State could progress towards such a system (within their own timeframe), within a national framework agreed between the Australian Government and the States.

Stephen Duckett, the discussant, commented that the health system 'often features in discussions of failures of federalism'. In his view, 'there is no doubt that the current division of responsibilities in the health sector is not acting in the best interests of an efficient and equitable health system'.

Duckett supported an integrated funding arrangement along the lines of Medicare Gold (proposed by Labor during the last election) and, also, improvements aimed at promoting more continuity of care at the primary care level, through register-based care. In the case of the medical workforce, he suggested the need to change the conception of federal-state divisions of power, and have both increased Australian Government national responsibility and increased State responsibility. In this context, he observed that 'professional registration and the like is now more appropriately handled at the national level, but the States should have greater involvement in health workforce allocation'.

The general discussion session focused on incremental versus more fundamental or 'big-bang' reform. There was a general view that many worthwhile reforms could be pursued without any change to federal-state roles and responsibilities. A number of participants recognised that many incremental changes were, in effect, prerequisites for more significant structural reforms.

Labour market

Andrew Stewart and Peter Anderson — the speakers for this session — argued that variations in labour market regulation across different jurisdictions create significant problems.

- There are costs and inefficiencies associated with the maintenance of overlapping federal and five separate State workplace relations systems —

including tribunals, registries and enforcement arrangements. And, the existence of federal and state systems inevitably raises jurisdictional issues, which can be costly and difficult to resolve.

- Legislation relating to labour market regulation has become increasingly complex and 'almost unintelligible' (Stewart) in parts, mainly due to excessive and unnecessary concern for constitutional validity and a lack of trust in regulatory institutions. This creates confusion and uncertainty.

Both Stewart and Anderson noted that there were opportunities for the Australian Government and the States to simplify and streamline labour market regulation under the current system. Beyond this, both agreed that it would be preferable to replace the current mixed regulatory model with a single, uniform system of workplace relations. They argued that, in a small economy such as Australia, there is no other practical way to overcome the inefficiencies, high transaction costs and uncertainties arising from multiple sources of regulation. Stewart also observed that national regulation could be flexible and did not necessarily imply a 'one size fits all' approach.

In reaching the conclusion that Australia should have a single, uniform workplace relations system, each speaker indicated that he had considered the arguments for competitive or cooperative solutions to the current problems, but found them wanting.

- Anderson argued that competitive federalism — including a possible federal 'opt-out' alternative — had only limited relevance and would not produce better outcomes. The potential benefits of such competition did not justify the retention of separate State systems. Stewart acknowledged that there might be gains from competition between federal and state jurisdictions, but questioned whether the virtues of trial and experimentation would outweigh the costs inevitably associated with two sets of institutions and processes in each State.
- As for a cooperative reform solution, Anderson considered it 'fanciful' to imagine that governments of different political persuasions could sit down and reach an agreed position on the content of an integrated workplace relations system. Stewart, while acknowledging that a great deal could be achieved by intergovernmental cooperation — as evidenced by NCP — agreed that it was difficult at present to see a cooperative way forward in labour market regulation.

Both speakers agreed that to achieve a unitary system, it would be better for the States to refer their industrial relations powers to the Australian Government.

John Freebairn, the discussant, while accepting the argument that a uniform national system of workplace relations would reduce duplication, confusion and lower transaction costs, was not convinced that there was a strong empirical case made for

uniformity over a competitive federalism model. He agreed that the choice in principle between these models involved a trade-off between the simplicity and lower transaction costs of a single system versus the potential for dynamic efficiency benefits under a competitive arrangement. However, in his judgement, there was no convincing empirical evidence on this trade-off and he suggested that this issue should be a high research priority.

Much of the general discussion focused on the merits of a single uniform system and whether any new workplace relations arrangements should allow for 'safe havens' to which employers could elect to move if the regime experienced at one level of government or jurisdiction was judged inferior to that of another level of government. While a national system found favour with most participants, others thought there were insufficient reasons for imposing a single national system, and that retaining an element of choice would be preferable.

Freight transport

The speakers' papers for this session were very different. Rod Sims' paper reviewed what had been achieved to date in land freight transport in Australia and examined options for further reform. The paper by Tony Wilson and Barry Moore looked at what had been learnt from an experiment in cooperative federalism — the National Transport Commission (NTC) and its predecessor the National Road Transport Commission (NRTC).

Looking back, Sims noted that reform agendas in both rail and road in the early-1990s were key planks of NCP — the Australian Government and the States agreed to create National Rail and to take a national approach to road freight vehicle operation and registration, driver licensing and road user charging. But, while the reforms made some headway, they left largely 'untouched' the key issue of competitive neutrality between road and rail.

Sims argued that to address the competitive neutrality issue, which was significantly distorting the price/service offering of rail compared to road, the required changes included more cost-reflective user charges for heavy road vehicles, mass-distance charging, factoring externalities into pricing (and therefore investment), aligning the framework for access regimes and providing certainty of access fee levels. He suggested that the two key steps required to deliver such reforms involved:

- CoAG re-engaging in transport reform and then continuing its involvement so as to ensure the required changes occurred; and

- strong national institutions — the NTC as an independent transport regulator; a single entity (such as the Australian Competition and Consumer Commission) to set user charges for both road and rail; and a National Transport Safety body.

Wilson and Moore, described the NTC, and its predecessor the NRTC, as an experiment in cooperative federalism. Noting the success of the NTC/NRTC in aligning the regulatory approaches of different agencies impacting on road transport, they stressed the importance of having an institutional body to drive the reform agenda. They claimed that without a sound decision-making process and an institutional framework to address implementation issues, effective national reform cannot be achieved.

Wilson and Moore considered that a number of key features of the NTC model had led to its successful operation, including the initial agreements at the Heads of Government level, the constrained and specific nature of the NTC charter and the robustness of the policy development process.

One of the limitations of the NTC model, according to Wilson and Moore, is that in the implementation phase, individual jurisdictions may choose to diverge from the policy intent underlying the reform program, or may implement changes only after a considerable delay. The NTC has no power to require consistency in the implementation phase and can only report divergences to the Australian Transport Council which can take action to address these inconsistencies.

Wilson and Moore saw a need for the establishment of an institutional framework which provided a nationally consistent approach to policy development (including infrastructure provision and funding and pricing principles for transport infrastructure). Such a framework would also need some teeth to secure consistency in operational matters associated with the implementation of agreed reforms. They acknowledged, however, that application of the current model in the more complex areas of reform (such as competitively neutral pricing arrangements) would involve not only the transport industry and portfolio, but also other sectors and portfolios (for example, environment, central agencies, occupational health and safety). This requires a far greater level of cooperation and engagement.

Henry Ergas, the discussant, commented that, notwithstanding some controversy about whether road charging is the major impediment to efficient modal choice in Australian transport, better road charging would, in any case, be highly worthwhile. He suggested that a move in that direction would be most effective if it were accompanied by some resolution of the long-term issues associated with the structure of our rail industry, notably the extent of vertical and horizontal integration. He also suggested that it is a major challenge to devise a structure to address these issues properly.

The general discussion that followed focused on how reform in this area could be progressed. The importance of re-engaging CoAG in the reform process was discussed, along with ideas for refinements to institutional arrangements to facilitate further reform. Also considered were some of the implications of moving towards more competitive pricing.

The way forward

This part of the roundtable program provided an opportunity for panellists and participants alike to explore challenges and issues associated with progressing reform in the future. Much of the discussion centred on the scope for achieving better outcomes from our federal system.

Scope for doing better

There was broad agreement that it is possible to get much more from our federal system. One important aspect was identifying and securing 'nationally sound policy outcomes'.

- John Langoulant considered that the degree of 'noise' in the areas of service delivery and regulatory behaviour suggested that 'things are not well in our federal arrangements'. Increasingly, as businesses are required to operate in a globalised marketplace, 'you have to think that perhaps there is a better structure of federal-state relationships which will enhance competition'. He emphasised the need to examine opportunities for reform in areas where businesses have to endure different administrative arrangements across jurisdictions (such as transport and labour markets).
- In his dinner address, Ken Henry referred to the lack of national markets for business inputs — 'it may not be too much of an exaggeration to say that the only significant business inputs for which we do have national markets are financial capital, post, telecommunications and aviation. Yet the case for governments facilitating the development of highly efficient national markets for key business inputs in a country as remote and geographically fragmented as ours is overwhelming'. He considered that 'parochialism and an aversion to markets' stood in the way of achieving efficient national markets for electricity, labour, water or freight transport.

Commenting on the way forward, participants generally saw a role for the competitive as well as cooperative dimensions of federalism. The competitive dimension was seen as continuing to provide incentives for governments to improve

public sector efficiency as well as the effectiveness of regulatory and institutional frameworks.

Many participants stressed the importance of cooperation between governments in facilitating a variety of reforms that could materially improve Australia's productivity and growth performance. In this context, several participants stressed the need for high level political leadership and dialogue for developing and refining reform initiatives and monitoring progress over time. Langoulant, for example, considered that in terms of looking forward, frequent CoAG meetings are essential if we are to get momentum into our reform activities.

In general, participants thought that the forward reform agenda was more complex and challenging than that of the 1990s. It was recognised that we are moving into more areas that require joint federal-state decision making and cooperation across portfolio boundaries, necessitating the use of mechanisms to facilitate whole-of-government action. And, in some areas — such as health, education, transport, industrial relations and natural resource management — there continues to be considerable debate about the best reforms. In addition, in many of these areas it is difficult to quantify the potential gains from reform. In turn, this can make it harder to secure community support.

That said, in general, participants recognised the need for exploring further opportunities for reform to secure higher living standards across Australia in the face of challenges such as globalisation, population ageing and securing environmental sustainability. In this context, one participant sounded a note of caution about the use of 'crisis' or 'challenge' rhetoric to try to galvanise support for reform. By way of illustration, he questioned the notion advanced by some participants that globalisation, and particularly the emergence of India and China, was a threat rather than an opportunity. Another participant pointed out that there was nevertheless a legitimate role for using the notions of opportunities or threats as motivating vehicles for challenging policy makers to think about how to do things better.

NCP — a model for future reform?

A number of participants regarded NCP as a landmark agreement that provided a useful model for national economic reform. Factors identified by participants, as having underpinned the success of the NCP model, included:

- an agreed reform framework and program;
- strong institutional arrangements to address implementation issues and to monitor progress over time; and

- the provision of financial incentives for progressing agreed reforms.

A number of participants suggested that financial incentives or payments would need to be part of a nationally coordinated reform process in the future. Another observation was that what appeared to be a relatively small amount of money, paid through NCP competition payments, seemed to drive a lot of reform. One participant argued that such payments should be viewed as 'reward sharing' rather than as a 'bribe'. Some participants, however, were of the view that the proponents of such payments often overlook the other, larger economic and social benefits that the States gain from undertaking reform. Another participant acknowledged the potential value of such payments, but argued that their extent and nature could only be sensibly determined by having regard to the specific characteristics of any reform program.

In commenting on the question of institutional design and models of good practice, Geoffrey Brennan emphasised the need to consider the capacity of institutions to suppress initiatives that could give rise to bad outcomes, as well as their capacity to facilitate good outcomes.

A window of opportunity?

There was a feeling expressed by participants that there was currently a rare opportunity for progressing economic reform at a national level, both in relation to completing unfinished business under NCP and to embracing new initiatives discussed at the June 2005 meeting of CoAG. One participant spoke about 'six months of blue sky' between electoral cycles; 'a window of opportunity that we want to make the most of if we can'.

In this context, Paul Kelly noted John Howard's comment that the June 2005 CoAG meeting was the most cooperative and productive of its kind that he had attended in nine years as Prime Minister. Kelly suggested that political leaders seemed to have come to the view that there is no dividend in buck-passing and blame-passing and there appeared to be a growing willingness to manage and contain Liberal-Labor differences.

In reflecting on this issue, as part of his dinner address to the roundtable, Ken Henry observed:

> The expansive [June 2005] CoAG, and related, reform agenda provide an unusual opportunity for policy makers at all levels of government to embrace the logic of markets in labour, energy, water and land transport; and to embrace the spirit of cooperative federalism. If they do, there is a very real chance that our peers in Washington and Paris will be talking about the golden age of Australian economic performance for decades to come.

Shortly before the finalisation of this publication, CoAG met in Canberra (10 February 2006). The communiqué from the meeting states:

> This was an historic meeting with significant outcomes. All governments have seized a unique opportunity to work together to deliver a substantial new National Reform Agenda embracing human capital, competition and regulatory reform streams. The National Reform Agenda is aimed at further raising living standards and improving services by lifting the nation's productivity and workforce participation over the next decade. CoAG agreed to concrete, practical initiatives in the areas of improved health services, skills recognition, infrastructure regulation and planning and a lessened regulatory burden on business. (CoAG 2006, p. 1)

1 Introduction

Gary Banks
Productivity Commission

Welcome to this roundtable on *Productive Reform in a Federal System*. That we have been able to attract such a distinguished and knowledgeable group of people reflects the importance and timeliness of this topic. We are also fortunate to be able to hold the roundtable in this fine old building, a symbol of our democratic heritage, in which the echoes of past debates still seem to hang in the air.

Australia's federal system appears to have been getting rather a bad press of late. It is increasingly viewed as anachronistic and an obstacle to progress. The political disagreements that we read about daily in the newspapers would only confirm this assessment in the public's mind. But of course as all (or most) of us here would acknowledge, federal systems of government have some important strengths and can be conducive to beneficial policy innovation over time. As in policy development itself, the question is how to maximise the benefits, while minimising the costs. In other words, the important thing is to get the best out of our federal system. After all, it is here to stay for the foreseeable future.

It is true that, compared with other federations, Australia has a high degree of shared roles and responsibilities across the different levels of government. It also has a relatively high level of centralisation. Accordingly, our federal arrangements exert an important influence over many areas of public policy and their implementation. The challenge is how best to exploit opportunities for cooperation as well as competition between governments to secure sound public policy outcomes.

Over the past 12 months or so, this has been at the heart of debates about public policies covering different aspects of Australia's economic and social infrastructure. Indeed, many of you here today, or the organisations or governments you represent, have contributed to this debate. Discussion has covered appropriate jurisdictional roles and responsibilities and intergovernmental arrangements — including in such key areas as energy and transport, education, the health system and industrial relations.

While currently highly topical, the importance of intergovernmental collaboration and competition for progressing national reform has, of course, been recognised for some time. From the early-1990s, the Special Premiers' Conferences followed by the Council of Australian Governments (CoAG), and other intergovernmental forums, have been responsible for many 'cooperative federalism' initiatives. These notably include the framework for National Competition Policy (NCP), as well as other important institutional developments which have seen the emergence of, for example, the National Transport Commission (represented at this roundtable). In addition, competition between jurisdictions has generated pressures for governments to do better in several areas, such as better mechanisms for regulatory review, improved governance arrangements for government business enterprises and the use of new funding mechanisms in areas like health, and education and training.

Through the opportunities provided by its public inquiries and other studies, the Productivity Commission has sought to contribute to an improved understanding of our federal system and practical ways in which the associated arrangements might be improved. Over the last few years, significant inquiries featuring federal issues have included the *Evaluation of the Mutual Recognition Schemes* (PC 2003) and *National Workers' Compensation and Occupational Health and Safety Frameworks* (PC 2004). And, in 2005, interjurisdictional issues have loomed large in three major Commission reports — *Australia's Health Workforce* (PC 2005b), *Economic Implications of an Ageing Australia* (PC 2005c) and the *Review of National Competition Policy Reforms* (PC 2005f).

In relation to the last, it is apparent that, by any measure, NCP has been a landmark achievement in nationally coordinated reform. Further, NCP and other microeconomic reforms have yielded a significant pay-off in productivity and income growth to the community. The upsurge in Australia's productivity growth since the early-1990s has been strong by historical as well as international standards. The assessment that past reforms have paid off for us has been reaffirmed internationally. Earlier this year, for example, the OECD (2005) suggested that Australia had become a model for other countries in the way it had created a 'competition culture' through its structural reforms across the economy. And only last month, the IMF (2005a) observed that Australia's competition policy framework had paid large economic dividends.

The success of microeconomic reforms generally, and the intergovernmental NCP reform process in particular, were not merely fortuitous. Rather, their success can be attributed to:

- recognition by all governments of the need for reform;
- broad agreement on the priority areas;

- a solid conceptual framework and information base to guide policy prescriptions; and
- some highly effective procedural and institutional mechanisms to implement reform (Banks 2005; PC 2005f).

Notwithstanding the improvement in Australia's economic performance in recent years, inefficiencies and performance gaps remain and will need to be addressed if Australia is to meet significant challenges ahead. Many of the areas offering the potential for significant benefits extend beyond the existing NCP reform agenda, but share in common the fact that coordinated national reform has a real and important role to play.

As noted earlier, the Commission has put forward its own ideas but it is far from alone in this. For example:

- in this year's Budget papers (Costello and Minchin 2005), the Australian Government said that in going forward it will be important for governments from all jurisdictions to clarify roles and responsibilities in order to improve productivity in the provision of services to the public while sustaining government finances;
- the Allen Consulting Group, in a report prepared last year for the Victorian Government — *Governments Working Together* (Allen Consulting 2004a) — called for new arrangements to achieve true collaboration among Australian governments for the provision of better health and education services;
- in June this year, the Australian Industry Group (2005), called for a major program of reform of Australia's intergovernmental relations — underpinned by a 'Hilmer style' inquiry into federal-state relations — observing that in just about every major policy area our current approach to intergovernmental relations presents barriers and obstacles to getting sensible outcomes; and
- Access Economics, in a report prepared earlier this year for the Business Council of Australia (BCA) — *The Speed Limit 2005–2025* (Access Economics 2005) — found that inconsistencies, duplication and additional costs associated with poorly coordinated or conflicting Federal, State and Local Government policies and regulations affect virtually every area of reform highlighted by the BCA and others.

These matters demand careful examination at the highest political level. At its June 2005 meeting, CoAG (2005) took this on board, particularly in the areas of infrastructure and Australia's health system. In the former case, CoAG agreed in principle to a national system of regulation for ports and export-related infrastructure. And for health, it was agreed that the system could be improved by, amongst other things, clarifying roles and responsibilities between governments and

by reducing duplication and gaps in services. These matters and more broadly the question of a reform program to succeed the NCP, are currently being reviewed by senior officials. They are due to report back to CoAG in December 2005 in the lead-up to a CoAG meeting in the first part of 2006.

It follows that developments over the next five or six months will be critical in determining the future course of reform within our federal system and thus the future living standards of Australians. The challenges in forging a national reform program are if anything greater now than in the lead-up to NCP, when there was much more agreement about both the need for reform and how to proceed. The best ways forward are less evident in 'new' reform areas like health. (Some unravelling of previous consensus is even evident in 'old' areas, like the national energy market.)

Against this backdrop, this roundtable provides an opportunity for the presentation and discussion of ideas which can advance the thinking of key players — and hopefully serve as a precursor to improved policy outcomes in what is an important window of opportunity.

The roundtable has been structured around three 'modules':

- the first is concerned with some generic issues associated with federal systems and their operation in principle and practice;
- the next involves three case studies to explore opportunities for improving arrangements in the key areas of health, the labour market and freight transport; and
- a final session will draw out ideas from participants on ways forward.

We have been very fortunate in the line-up of speakers and discussants, and are especially grateful to those who have prepared the papers, which I am sure you will agree are of high quality.

Our opening speakers, Jonathan Pincus and Cliff Walsh, will discuss a number of generic issues associated with the institutional design and operation of federal systems, primarily focusing on Australia. Key issues include developing effective governance arrangements for handling the assignment of roles and responsibilities between governments, the need for ongoing periodic reviews of these assignments and getting the balance between cooperation and competition between governments right. Related to this is the effective design of mechanisms to promote the best that 'cooperative' and 'competitive' federalism have to offer, while minimising the risks of coordination failure and welfare-reducing outcomes.

We then move to three case study sessions. Inevitably a choice had to be made to ensure a manageable program. Reflecting the Commission's own work, and the broader public debate, the three areas chosen — health, labour market reform and freight transport — are all important and involve particularly challenging federal issues. The speakers examine recent attempts at improving arrangements, including finance and delivery in the case of health and freight transport, as well as ideas for securing further improvements:

- the papers by Vince FitzGerald and Andrew Podger canvass the challenges facing our health care system and reform principles and options to secure better outcomes;
- in the final session today, Andrew Stewart and Peter Anderson explore ways of improving the regulatory regime for the labour market and assess the Australian Government's proposed national workplace relations system; and
- in the first session tomorrow, Rod Sims identifies opportunities for intergovernmental action to advance further significant reform to our freight system, and Tony Wilson will comment on the National Road Transport Commission/National Transport Commission model as a mechanism for advancing land transport reform.

The roundtable concludes with a panel discussion designed to harvest ideas about useful ways forward. Geoffrey Brennan, Paul Kelly, John Langoulant and John Roskam will give us their views and prompt a general discussion. This will hopefully crystallise some key themes from the preceding discussions, including how lessons from recent experiences can aid the future development of policy.

The Commission is publishing the papers from this roundtable, along with summaries of the general discussions. This will enable wider dissemination of the views and insights expressed at this gathering, as well as contributing to a wider public discussion of the issues. Reflecting the topical nature of the papers, the Commission has agreed to their public release in draft form at the conclusion of this roundtable.

That said, to encourage the expression of forthright views over the next one and a half days, the Chatham House rule will apply — that is, views and ideas may be reflected in the roundtable proceedings, or may be otherwise reported by participants, but may not be attributed to individuals.

PART A

INSTITUTIONAL FRAMEWORKS TO PROMOTE PRODUCTIVE OUTCOMES

2 Productive reform in a federal system*

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Productivity Commission

2.1 What is a federation?

Federations are a common form of governance. About 25 of the world's 193 countries have federal systems of governance, accounting for up to 40 per cent of the world's population and about 50 per cent of global GDP (box 2.1).

Box 2.1 **Australia's federation is in good company**

Australia has the distinction of being one of the oldest continuing federations after the United States (1789), Switzerland (1848) and Canada (1867). Other federations include Argentina, Austria, Belgium, Bosnia and Herzegovina, Brazil, Comoros, Ethiopia, Germany, India, Malaysia, Mexico, Micronesia, Nigeria, Pakistan, Russia, St. Kitts and Nevis, Serbia and Montenegro, South Africa, Spain, United Arab Emirates and Venezuela. A number of unitary states — for example, the UK and Italy — have incorporated some federal design features into their governance structures. Beyond these countries, the European Union is a special case involving a mix of federal and unitary hybrid institutions — effectively a 'quasi-federal' association of countries.

Source: Griffiths and Nerenberg (2002).

Federal systems of governance have three defining features, namely:

- the existence of at least two sovereign levels of government — a national or central government and sub-national or state governments;
- provision for independent or autonomous actions by each level of government; and

* This paper reproduces the theme chapter from the Productivity Commission's 2004-05 Annual Report (PC 2005a).

- an allocation or assignment of powers and functions to each level of government.

Essentially, federalism is a system of governance which provides for action by a national or central government for certain common functions together with independent actions by sub-national units of government, with each level of government accountable to its own electorate. In this way, a citizen of a federation is a member of two sovereign polities simultaneously.

Federal systems have advantages and disadvantages

Federal arrangements offer their citizens some important potential advantages compared with unitary states. These include:

- dispersing power across multiple jurisdictions, to encourage more responsive government;
- allowing for diversity in the provision of sub-national goods and services in response to voter preferences, while facilitating the provision of common — national type — goods and services by a central government;
- enhancing the competitive pressure on governments to respond to the preferences of citizens in their jurisdictions; and
- creating opportunities for interjurisdictional learning from different policy approaches.

However, these advantages need not translate into net benefits to the community, because federal systems also have a number of potential disadvantages, including:

- higher transaction costs from diversity and fragmentation in rules and regulations;
- scope for 'destructive' interjurisdictional competition; and
- inefficiencies that arise when functions are not well allocated or where governance arrangements relating to them are poorly designed.

Who should do what?

The scope to capture the potential benefits of a federal system while minimising the potential costs is heavily dependent on the assignment of functions between governments (including the possibility of realignments over time) and the effectiveness with which governance arrangements (relating to intergovernmental coordination and cooperation) are able to adapt to changing conditions.

The subsidiarity principle

The subsidiarity principle provides some guidance as to the appropriate level of government for a particular function. Under this principle, responsibility for a particular function should, where practicable, reside with the *lowest* level of government (see, for example, CEPR 1993; Kasper 1995, 1996). This rests on four main considerations:

- sub-national governments are likely to have greater knowledge about the needs of the citizens and businesses affected by their policies;
- decentralisation of responsibility and decision making makes it easier to constrain the ability of elected representatives to pursue their own agendas to the disadvantage of citizens they represent;
- intra-national mobility of individuals and businesses exposes sub-national governments to a reasonable degree of intergovernmental competition; and
- initial emphasis on the lowest level of government encourages careful consideration or testing of the case for allocating a function to a higher or national government and thereby guards against excessive centralisation.

A key issue in applying the subsidiarity principle is to establish the meaning of 'where practicable'. Although the public finance literature provides some guidance, there is considerable scope for differences of view in relation to the appropriate assignment of many expenditure, tax and regulatory functions.

That said, there is broad support for assigning responsibility for a function to the *highest* level of government — the national government — where:

- there are significant interjurisdictional spillovers associated with the provision of a good or service at the sub-national level (for example, interstate transport systems);
- there are readily identifiable areas of shared or common interest or sizeable economies of scale and scope arising from central provision or organisation (for example, defence, international or external affairs and social welfare support);
- a diversity in rules or regulations is likely to give rise to high transaction costs with insufficient offsetting benefits (for example, regulation of companies, transport, the financial sector and trading provisions covering weights and measures); and
- there is scope for mobility of capital and people across jurisdictions to undermine the fiscal strength of the sub-national level of government (for example, as arises with the income, capital gains and corporate tax bases; or with welfare entitlements).

Fiscal considerations

A further consideration in the assignment of functions is the principle of fiscal equivalence. Strictly applied, this principle requires that each level of government should finance its assigned functions with funds that it raises itself (Kasper 1995). Related to this, Brennan and Buchanan (1983) have argued for decentralised powers in relation to taxes and expenditure. Specifically, where the subsidiarity principle supports the allocation of a function to a lower level of government, they argue that both the necessary expenditure and taxing powers should also be delegated to that level of government. Such an assignment promotes accountability by placing a constraint on the extent to which the political agenda can deviate from the preferences of citizens.

Even so, a wide range of considerations impinge on the desirable allocation of expenditure and taxing functions between governments and the implied extent and nature of any intergovernmental transfers to address any resulting *vertical fiscal imbalance*. Vertical fiscal imbalance refers to situations where the revenue raising powers of one level of government are insufficient to meet their expenditure responsibilities and, for the other level, excessive, thus requiring a system of inter-governmental transfers or grants to correct the imbalance.

The existence of vertical fiscal imbalance does not, of itself, necessarily reflect a problem in the design of the fiscal arrangements for a federation. However, specific aspects of the intergovernmental transfer arrangements used to address vertical fiscal imbalance in various federations, including Australia's, have given rise to a variety of concerns (see below).

No single best model

There is no single 'best' model for assigning functions between governments (see, for example, Joumard and Kongsrud 2003; OECD 1997). Moreover, changing circumstances may make it desirable to realign functions over time. Furthermore, however carefully functions are allocated, substantial interaction and cooperation among governments are likely to be necessary to ensure the effective funding and delivery of services. There is, of course, considerable scope for variations in the design and operation of governance arrangements for this purpose.

Reflecting all this, there is considerable diversity in the observed assignment and governance arrangements of federations. They display varying degrees of exclusivity or overlap in the assignment of functions, as well as of decentralisation or integration of coordination tasks. Further, these structures are not fixed by initial constitutional frameworks — they evolve over time in response to various factors, including the dynamics of the political process and judicial reviews. Consequently,

the assignment of functions between different levels of government needs to be reviewed from time to time to determine whether realignments are warranted in response to changing economic and social conditions.

Australia's federation is distinctive

Australia's federation comprises three tiers of government — the Australian Government, with designated and delegated powers; six State Governments, with residual powers, and two Territory Governments, with State-type powers; and local government authorities with delegated powers and responsibilities. The following discussion focuses on the first two tiers of government.

The roles and responsibilities of the Australian Government and the six State Governments are defined by the Australian Constitution and the Constitutions of each of the States (box 2.2).

Box 2.2 The division of powers between the Australian and State Governments

The division of powers under the Australian Constitution provides the Australian Government with:

- a small number of *exclusive* powers — mainly in respect of customs and excise duties, the coining of money and holding of referendums for constitutional change; and
- a large number of areas under Section 51 where it can exercise powers *concurrently* with the States. However, to the extent that State laws are inconsistent with those of the Australian Government in these areas, the laws of the latter prevail (Section 109).

State Governments have retained responsibility for all other matters.

While the list of legislative powers for the Australian Government does not mention a number of specific functions (such as education, the environment and roads), this does not preclude action by the Australian Government in these areas. For example, while the Australian Government has no specific power in relation to the environment, it can legislate in this area under its external affairs power in support of any international agreement covering the environment.

Further, the Australian Government can influence State policies and programs by granting financial assistance on terms and conditions that it specifies (Section 96).

Australia's federal model has a number of distinctive features.

- A relatively high degree of shared functions between governments giving rise to a diverse set of intergovernmental arrangements to handle the associated coordination challenges (see, for example, Galligan 1995 and Painter 1998).
- A strong centralising trend over time (aided, in part, by High Court decisions which have interpreted the powers of the Australian Government in a broad manner) has seen the emergence of a relatively high degree of centralisation (see, for example, Keating and Wanna 2000).
- A relatively high degree of vertical fiscal imbalance and of transfers directed at fiscal equalisation (see, for example, NCA 1996).
- Innovative initiatives in cooperative federalism — notably in areas of competition policy and the environment. Beyond these, there have been some new forms of collaborative leadership/sponsorship institutions (such as the Special Premiers' Conferences and the Council of Australian Governments) to adapt public policies to emerging domestic and international challenges (see, for example, Galligan 1995; Gyngell and Wesley 2000; Wanna and Withers 2000).

The performance of Australia's federal system has come under increased scrutiny in recent years, as the need to lift the performance of the economy has raised policy issues extending beyond the responsibility of individual jurisdictions. Reflecting this, a variety of ideas to make the federation work better have been put forward (box 2.3).

While it is clear that federalism is embedded in our Constitution, a fundamental issue relates to how we can secure the best possible outcomes from our federal system. In the Commission's view, a useful way of thinking about this challenge is in terms of exploiting opportunities for both 'competitive' and 'cooperative' federalism, while minimising the risks of destructive competition and coordination failure.

Box 2.3 **Perspectives on Australia's federal system**

- Looking across the federal system, we find areas where our federation works well, areas where the case for rationalisation is strong, and areas where a more incremental approach is the best way to proceed. (*Howard 2005b, p. 5)*
- We must address the increasingly untenable coexistence of multiple State industrial systems in conjunction with the federal system. … If a national system of corporate and taxation regulation is desirable and achievable, then there is no reason why a unitary or national system is not just as appropriate to govern how these corporations employ their staff. (*Andrews 2005, pp. 17–8*)
- We should be thinking about untangling this mess, creating simpler lines of responsibility in our federal system. ... And that means a serious debate about the tertiary education sector, the possibility of the States transferring their legislative responsibilities for universities holus-bolus to the Commonwealth, or about a hospital system or disability services being better managed by just a single level of government without all the perverse incentives for cost-shifting and finger-pointing that exist today. (*Carr 2004, p. 6*)
- Going forward, it will be important for the Australian Government and the States to clarify roles and responsibilities in order to improve productivity in the provision of services to the public while sustaining government finances. Clarification of roles will require consideration of national strategic priorities and judgements as to the tier of government that is likely to discharge those priorities most effectively. (*Costello and Minchin 2005, p. 4–18*)
- The State level of government is generally best placed to respond to meeting particular needs, being closer to local communities, with the Commonwealth having a role in national aspects. The issue is therefore not whether the Commonwealth and States should both remain involved in the core social programs in health and education, but how. ... New arrangements are needed to lock in true collaboration among Australian governments. (*Allen Consulting 2004a, p. xiii and p. xvii*)
- Australia's federation needs new life breathed into it to the benefit of the community and business. In just about every major policy area our current approach to intergovernmental relations presents barriers and obstacles to getting sensible outcomes. … The time has come to take a more holistic approach to our system of intergovernmental relations so that our federation works for us rather than against us. (*Australian Industry Group 2005*)
- Getting better results out of areas where federal-state activities intersect is vital. Inconsistencies, duplication and additional costs associated with poorly coordinated or conflicting State-Federal (and local) Government policies and regulations affect virtually every area of reform highlighted by the BCA and others. (*Access Economics 2005, p. 26*)

2.2 Competitive federalism in action in Australia

Democracies are distinguished by electoral competition — a government must submit itself to the will of the people in competition with other political parties. By dispersing power across governments, federalism adds another dimension to electoral competition, providing more opportunities for this discipline to be exercised by citizens over time.

Federal systems offer two additional forms of competitive discipline on governments — vertical and horizontal competition (box 2.4).

Box 2.4 **What are 'vertical' and 'horizontal' competition?**

The citizens of a State within a federation of the Australian kind get to vote for two sovereign governments, both of which operate over the same area. Any Australian can, accordingly, stay put in one State, yet seek responses from two governments, the State and the Australian, both with sovereign powers of taxing, spending and regulation over him or her.

Vertical competition arises where either the national or state governments enter a specific area in direct competition with the other level of government. While not without costs, it can give rise to improved service delivery, or provide a basis for testing new approaches to service delivery.

Horizontal competition refers to the discipline imposed on governments by the possibility of citizens (and businesses) exercising their right to relocate from one State or country to another ('voting with their feet') in response to fiscal and regulatory differences.

The option of migration opens up the possibility of horizontal competition between the States of Australia, or between Australian States and other countries, whether or not those States or countries are formed into a federation. However, federal systems make this form of competition stronger, since it is normally much easier to move within a country than between countries.

Vertical competition

Vertical competition is unique to federations. The simultaneous involvement of more than one government in a single area is often undervalued, being primarily seen in terms of wasteful overlap and duplication. However, some overlap may be beneficial if it expands choices or promotes improvements to service delivery over time such that the benefits outweigh the associated costs. Mechanistic responses to apparent overlap and duplication run the risk of forfeiting the potential benefits that vertical competition can bring.

Two distinct forms of vertical competition are considered here:

- national regulatory regimes operating in parallel with existing state schemes; and
- direct competition through the actions of either a national government or state government in a specific area.

An opt-out alternative

The first form of vertical competition involves the creation by the national government of an opt-out alternative to State-based regulatory regimes, where the case for a single national regime is yet to be demonstrated or the operation of such a regime is not feasible.

A useful illustration of some of the issues which arise with the development of an opt-out alternative is provided in the Commission's inquiry report on *National Workers' Compensation and Occupational Health and Safety Frameworks* (PC 2004). The Commission's proposals were targeted at reducing the compliance burdens, costs and inefficiencies created for multistate employers and their employees from the differing regulatory requirements imposed by State and Territory Governments for occupational health and safety and workers' compensation.

To coordinate strategies across jurisdictions and thereby improve the regulatory framework for workers' compensation, the Commission recommended the formation of a new national body to facilitate improved consultative mechanisms to address common issues and to promote greater national consistency in scheme elements. In parallel with this, and to address directly the compliance burdens and costs of multistate employers, the Commission recommended that the Australian Government progressively expand a scheme offering alternative national coverage for all employers which would operate alongside the existing State and Territory schemes.

Beyond this, the Commission recommended that all jurisdictions collectively pursue improvements to workers' compensation schemes by establishing a formal review mechanism similar to that already in place for occupational health and safety. This should lead to an increasing level of national consistency (and perhaps for some scheme elements, national uniformity) over time. While supporting a number of the Commission's recommendations, the Australian Government indicated that it did not support key elements of the national framework model. This included the opt-out alternative, apart from some limited access for some firms to self-insurance under the Comcare scheme (Costello and Andrews 2004).

Direct competition

A topical example of vertical competition arising from the actions of the Australian Government is the Australian Technical Colleges initiative. This involves the creation of 24 colleges in regions across Australia to provide academic and vocational education for up to 7200 students each year (Nelson and Hardgrave 2005). The aim is to strengthen Australia's vocational education and training system by adopting a new approach to attracting and training young people in specific trades.

Commencing in 2006, the colleges will be located in regions suffering skills shortages and high rates of youth unemployment, and which are supported by a significant industry base. Their principals will be appointed by a College Governing Council and have considerable autonomy, including being able to engage teachers on a performance pay basis. It is also envisaged that local industry and community representatives will have a role in the governance of the colleges.

State Governments have also entered some areas in direct competition with Australian Government programs, often with the aim of addressing perceived gaps in services or to broaden access to programs. For example, notwithstanding federal action to assist older people in making the transition from hospital to home or other long-term care settings, some State Governments have introduced their own transitional care arrangements to expand the service options available to the elderly. These State initiatives have also sought to reduce the extent to which some hospital beds are tied up for extended periods providing 'aged care' services.

Victoria, for example, funds a number of initiatives, including a targeted Interim Care Program which provides temporary support for older people in hospital who are waiting for placement in a residential care facility. An integral part of this program is the provision of funding for hospital managers to lease beds from residential aged care providers. In some cases, hospitals have taken advantage of spare bed capacity in aged care facilities that were due to close as a result of the bed licences being transferred to other areas (DHS 2001). Elsewhere, it has meant negotiating sub-contract agreements with residential care facilities to provide off-site interim care services for elderly hospital patients until a permanent place becomes available (Southern Health 2004).

Horizontal competition

A key beneficial element of horizontal competition between States relates to getting the so-called 'economic fundamentals' right. Beyond this, scope exists to extend horizontally-based competitive disciplines through the use of yardstick competition.

Intergovernmental fiscal transfers can dilute the 'incentives' created by horizontal competition for State Governments to improve their performance. Sometimes, it is desirable for governments to take collective action to preclude or limit destructive forms of horizontal competition.

Getting the 'economic fundamentals' right

There are various areas in which State Government decisions affect the attractiveness of their State as a place for doing business as well as the living standards of their residents.

- States are responsible for much of Australia's public infrastructure. Often they are directly involved in the provision of essential services — energy, transport, water — or have responsibility for regulating private suppliers.
- States have responsibility for many areas of regulation, including business, social and environmental.
- States raise a significant proportion of their revenue requirements through taxes and charges which affect the competitiveness of businesses and the disposable incomes of households.
- States are primarily responsible for the delivery of a wide range of services including health and aged care, family and community services, primary and secondary education and vocational training.
- States also provide a variety of general government services to firms and individuals in their jurisdictions.

Collectively, these areas can be seen as constituting the 'economic fundamentals' of a State. Within each area, there is scope for horizontal competition to encourage good outcomes. For example, if some States charge excessive prices for essential services, or allow the reliability of their electricity and transport networks to deteriorate, or levy excessive payroll taxes or allow access to important health and community services to worsen, then better performing jurisdictions are likely to find some firms and households migrating their way. This in turn provides an incentive for governments to improve their performance — to attain a better balance between the burden of taxation and the benefits of public spending; and similarly for regulation. Hence, competition between States on the 'economic fundamentals' is an important benefit of a federal system.

Another dimension of such competition arises from the demonstration and learning effects associated with policy innovations by governments. Across Australia's States and Territories, there are various examples of such innovations and associated demonstration effects.

- During the early to mid-1980s, South Australia, Tasmania and Victoria were pioneers in establishing mechanisms for the review of business regulations — setting up one-stop review mechanisms ahead of the Australian Government and other States.
- The development of broadly-based commercialisation and corporatisation initiatives to improve the performance of government business enterprises was facilitated by important initial reform efforts in New South Wales and Victoria during the late-1980s and early-1990s.
- The Northern Territory was a first mover in a number of areas of education and training, including the introduction of flexible delivery strategies to improve access to education and training from the late-1980s, introducing competency-based training into apprenticeships and traineeships and the use of skills-based rather than time-based recognition of on the job training.
- Casemix funding of public hospitals has now been widely adopted following the lead provided by Victoria in 1993.
- In the industrial relations area, some major reforms occurred in State jurisdictions well ahead of reforms introduced at the national level. In Queensland, formal provision for individual agreements was introduced in 1987, while the first comprehensive reform of industrial relations processes and practices occurred in New South Wales as a result of the introduction of the *Industrial Relations Act 1991* (Wooden 2000).

Yardstick competition

Assessing the performance of governments in delivering services for which there is (or can be) no competitive market, and where criteria such as access and equity loom large, is no simple matter. Individually, governments can set objectives and collect and compare information on their individual performance over time, but how do they know what is potentially achievable or best practice?

Federations provide their governments and citizens with an important opportunity for addressing these questions by comparing performance and learning from what other jurisdictions are doing and how they are doing it. Such intranational performance comparisons are facilitated by commonalities in institutional and governance arrangements, as well as in community expectations, the lack of which often bedevils international comparisons. Further, the basis for these comparisons is strengthened by them having emerged from decentralised sovereign political processes.

The Review of Government Service Provision, initiated by Australian governments in July 1993, created a framework for comparing the performance of government service providers. While Australian Government as well as State service providers are included in the review, State-based providers dominate and hence it is appropriately viewed as a manifestation of horizontal competition.

The Review embraces a diverse range of services, including education, health, justice, emergency management, public housing and community services spanning child care to aged care. Together, these services involved expenditure of almost $85 billion, or around 60 per cent of government recurrent expenditure in 2003-04. This is equivalent to about 10.4 per cent of Australia's GDP (SCRGSP 2005).

These services are vital to the community's wellbeing. Improving them can result in major social and economic benefits. Performance information can assist governments to improve their service delivery through yardstick competition — by facilitating comparisons with programs with similar objectives within the same jurisdiction, across jurisdictions, or between modes of service delivery.

The performance data contained in the annual review:

- allow agencies to identify peer agencies that are delivering better or more cost effective services from which they can learn;
- generate additional incentives for agencies to address substandard performance; and
- allow governments to verify good performance and indicate whether agencies are getting it right.

As a result, performance comparisons can be a catalyst for improving the effectiveness and efficiency of government activities that are not normally subject to direct competitive pressures.

A performance monitoring framework was established for government trading enterprises in July 1991 which, like the government services framework referred to above, has involved regular reporting of performance indicators for these enterprises to promote yardstick competition (see, for example, PC 2005d and SCNPMGTE 1994).

The fiscal federalism dimension to competition

As noted earlier, the vertical fiscal imbalance created by the assignment of expenditure and taxation powers between governments within Australia requires an extensive system of intergovernmental transfers to redress the imbalance. The design and operation of these arrangements (which also embody a significant degree

of horizontal fiscal equalisation between the States) has given rise to a number of concerns. These concerns include, for example, the potential for distortions to the process of horizontal competition arising from the dilution of incentives for expenditure and tax reform, and the scope for gaming under the equalisation process used by the Commonwealth Grants Commission to determine grants to the States.

The sources of the efficiency-related distortions (including their extent and implications), together with the perceived inequities of the equalisation system and its complexity, have been subject to longstanding debate (see, for example, Commonwealth Grants Commission 2004; Garnaut and Fitzgerald 2002; IC 1993; National Commission of Audit (NCA) 1996; New South Wales Tax Task Force 1988; New South Wales Treasury 2005; Nicholas 2002; Peloquin 2003; Petchey 2001; Victorian Government 2005). Reflecting differences of view about the policy significance of these concerns, reforms to the equalisation process to date have largely been confined to trying to lessen its complexity and improve its transparency.

Competition can also be destructive

Horizontal competition can give rise to favourable outcomes by providing incentives for the development of an appropriate level and mix of State Government expenditures and taxes, as well as efficiency in the provision of services. However, there is also scope for some perverse outcomes through what is commonly referred to as destructive competition. Two prime examples are interstate bidding wars to attract major projects, and some forms of tax competition.

State Governments 'bid' for major projects because of the perceived gain to them in terms of increased income and employment. However, this form of rivalry between States for development at best shuffles jobs between regions, and at worst reduces overall economic activity in Australia (Banks 2002; IC 1996; PC 2005f). In general, firms' locational choices in relation to new investments are best guided by the underlying economic strengths of a State rather than selective inducements. A selective (or firm specific) reduction in, say, payroll taxes or utility charges, is likely to be inferior to a general but smaller reduction in tax rates or charges allied to 'efficient government'. Consequently, bidding for major projects is likely to have little or no positive effect on the welfare of residents of the initiating States, and even less for Australians generally.

Even so, States find it difficult to avoid such competitive bidding because of the perceived costs of withdrawal, both economic and political. Avoiding or substantially lessening this problem requires collective action.

All State and Territory Governments except Queensland recently signed an agreement to restrict the use of selective assistance to attract investment. This has been a significant initiative. That said, as the Commission observed in its *Review of National Competition Policy Reforms*, there are some deficiencies in the current agreement that could usefully be addressed (PC 2005f). In particular, there are no formal mechanisms for policing the agreement and no sanctions for non-compliance. Also, Queensland and the Australian Government are not signatories.

Generally, when a tax base is highly mobile between States, differences in tax base definitions and rates create incentives for the tax base (that is, businesses or workers) to relocate. In these circumstances, destructive tax competition between States can occur, especially if competition is by way of special exemptions and concessions. Tax competition between States is unlikely to yield sustainable benefits in such cases and can result in a deterioration in the overall performance of the tax systems of the States concerned.

Australia's experience with death duties is often cited as an example of this phenomenon. Effectively, the migration of more affluent elderly people to Queensland, following the abolition of death duties by that State, induced other States to do the same. Consequently, all States lost access to a source of revenue, with knock-on effects of higher rates of other taxes and charges or a reduced capacity to provide government services (see, for example, New South Wales Tax Task Force 1988). Whether this was constructive or destructive tax competition is arguable — some economists assert that death duties should be included in an efficient mix of tax bases. But death duties certainly proved politically unpopular, and the Australian Government did not fill the gap.

2.3 Cooperative federalism in action in Australia

Far from operating as independent sovereignties, governments in many federations, including Australia, have developed an extensive and varied array of intergovernmental cooperative arrangements. They include mutual recognition regimes, harmonisation of regulation, the adoption of national standards, reassigning roles and responsibilities between governments, developing better governance arrangements to promote effective coordination in areas of shared responsibility, and the use of integrated interjurisdictional frameworks to develop and oversee the implementation of various reform measures.

These arrangements recognise important interdependencies and shared objectives between governments (as servants of the people). Such arrangements have long been recognised as essential to secure good policy outcomes. Indeed, from the early-1990s, new cooperative arrangements, linked to the work of the Special

Premiers' Conferences and the Council of Australian Governments (CoAG) have facilitated a fundamental reshaping of economic policy making in several key areas (PC 2005f).

It is useful to look at these arrangements from the perspective of what motivates governments to cooperate. Three broad motivations can be identified: to deal with interjurisdictional spillovers or externalities; to lessen domestic impediments which increase costs and restrict the internal movement of goods and people (that is, to promote the development of national markets); and to secure effective policy outcomes in areas that are perceived to have national significance.

Interjurisdictional spillovers

Where significant interjurisdictional spillovers occur, an individual State may overproduce or underproduce a good or service because, from its narrow perspective alone, it may overlook costs or benefits which affect other jurisdictions.[1]

Many natural resource and environmental systems are characterised by cross-border spillovers or externalities. Reflecting this, a wide range of intergovernmental strategies and programs have been developed over the years to secure better outcomes than would otherwise occur.[2] One such example is the Murray-Darling Basin Natural Resource Management Strategy, the background to which is briefly outlined in box 2.5.

As outlined earlier, there is also scope within federations for jurisdictions to engage in activities which give rise to destructive competition and associated negative cross-border spillover effects. Examples include competitive bidding by jurisdictions for major projects and some forms of tax competition which result in the erosion or loss of otherwise effective tax bases. Collective action by jurisdictions in the form of, say, intergovernmental agreements can limit wasteful rivalry in these areas.

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1 Negative fiscal spillovers — especially the 'exportation' of tax burdens — motivated the 1901 Constitutional assignment of customs duties and excises.

2 Examples include: the National Strategy for the Conservation of Australia's Biological Diversity; the National Greenhouse Response Strategy; the National Water Quality Management Strategy; the National Action Plan for Salinity and Water Quality; the Murray-Darling Basin Natural Resources Management Strategy; the National Forest Policy Statement; the National Strategy for Conservation of Australian Species and Ecological Communities Threatened with Extinction; the National Weeds Strategy; the National Strategy for Ecologically Sustainable Development; the National Framework for the Management and Monitoring of Australia's Native Vegetation; and the National Framework for Energy Efficiency.

Box 2.5 **The Murray-Darling Basin Natural Resource Management Strategy (MDBNRMS)**

The MDBNRMS provides an intergovernmental framework for integrated catchment management within the Murray-Darling Basin. The strategy is one of the largest management initiatives of its type in the world, covering an area of over one million square kilometres.

The strategy and related agreement brings together the Australian, New South Wales, Victorian, South Australian and Queensland Governments, in equal partnership, to address issues of common concern within the catchment. The Australian Capital Territory Government has observer status.

The MDBNRMS aims to address some of the key environmental and resource allocation problems facing the Murray-Darling Basin. According to the Murray-Darling Basin Ministerial Council (1990) these include: rising saline water tables; dryland salinity; loss of riparian and riverine biodiversity; reduction in water quality; and excessive water diversion and over-allocation of water licences within the basin.

Source: Derived from PC (1999a, p. 214).

Promoting national markets

A significant part of the microeconomic reform agenda of Australian governments since the late-1980s has been directed at removing cross-border regulatory impediments to the efficient operation of the economy. Much of this agenda has been fashioned in response to pressures to improve the international competitiveness of the economy, including by removing domestically-based cost-increasing impediments and restrictions on productivity improvement exposed by the removal of protection against import competition.

As the process of reform gathered pace, it became clear that aspects of Australia's competition policy framework were impeding performance across the economy and constraining the scope to create national markets for infrastructure and other services. Hence, in April 1995, the Australian and State and Territory Governments committed to the implementation of a wide-ranging National Competition Policy (NCP) that included general as well as sector-specific reforms (box 2.6). The associated policy framework drew heavily on a blueprint established by an earlier independent inquiry, generally referred to as the Hilmer Inquiry (Hilmer, Rayner and Taperell 1993).

NCP has been a landmark achievement in nationally coordinated economic reform (PC 2005f). At the June 2005 meeting of CoAG, Heads of Government stated:

> A collaborative national approach was the cornerstone of successful implementation of the NCP reform agenda. It drew together the reform priorities of the Commonwealth, States and Territories to improve Australia's overall competitiveness and raise living standards… . (CoAG 2005, p. 4)

Securing effective policy outcomes in areas of national significance

As noted earlier, a distinctive feature of Australia's federation is that many functions are shared, rather than being exclusive to one level of government. This has made it essential for governments to collaborate and cooperate in a wide range of areas to secure effective policy outcomes.

In practice, the funding and delivery of a number of significant services (including transport, housing, health, aged care, disability services, education and child care) are organised through various intergovernmental arrangements. Other areas with service interfaces between governments include environmental management, workers' compensation, occupational health and safety, industrial relations and indigenous affairs.

The design of intergovernmental arrangements for each of these areas has important implications for the cost-effective provision of services. Inefficiencies arise where there is unhelpful duplication of effort, opportunities for perverse forms of cost or risk shifting, and ineffective management of different parts of the overall service package. Such inefficiencies are not necessarily the result of shared functions as such. Rather, they usually arise because of ambiguity about the responsibilities of different levels of government and other weaknesses in related governance arrangements.

For some, the solution to the perceived problems involves renegotiating the assignment of functions and responsibilities between governments, to cede responsibility to one level of government and thereby secure clearer lines of accountability and responsibility. The National Commission of Audit (NCA 1996), for example, took this view in several areas and made recommendations for realignments of responsibilities between the Australian and State Governments.

Box 2.6 **An overview of the NCP reforms**

General reforms

- Extension of the anti-competitive conduct provisions in the *Trade Practices Act* to unincorporated enterprises and government businesses.
- Reforms to public monopolies and other government businesses:
  - structural reforms — including separating regulatory from commercial functions; and reviewing the merits of separating natural monopoly from potentially contestable service elements; and/or separating contestable elements into smaller independent businesses; and
  - competitive neutrality requirements involving the adoption of corporatised governance structures for significant government enterprises; the imposition of similar commercial and regulatory obligations to those faced by competing private businesses; and the establishment of independent mechanisms for handling complaints that these requirements have been breached.
- The creation of independent authorities to set, administer or oversee prices for monopoly service providers.
- The introduction of a national regime to provide third-party access on reasonable terms and conditions to essential infrastructure services with natural monopoly characteristics.
- The introduction of a Legislation Review Program to assess whether regulatory restrictions on competition are in the public interest and, if not, what changes are required. The legislation covered by the program spans a wide range of areas, including: the professions and occupations; statutory marketing of agricultural products; fishing and forestry; retail trading; transport; communications; insurance and superannuation; child care; gambling; and planning and development services.

Sector-specific reforms

- *Electricity*: Various structural, governance, regulatory and pricing reforms to introduce greater competition into electricity generation and retailing and to establish a National Electricity Market in the eastern States.
- *Gas:* A similar suite of reforms to facilitate more competitive supply arrangements and to promote greater competition at the retail level.
- *Road transport:* Implementation of heavy vehicle charges and a uniform approach to regulating heavy vehicles to improve the efficiency of the road freight sector, enhance road safety and reduce the transaction costs of regulation.
- *Water*: Various reforms to achieve a more efficient and sustainable water sector including institutional, pricing and investment measures, and the implementation of arrangements that allow for the permanent trading of water allocations.

Source: PC (2005f, p. xv).

Such realignments also raise funding issues, given the marked differences in the revenue raising and expenditure positions of the national government compared with the States. For example, the Australian Government currently redirects revenue to the States which accounts for about half of their expenditures. The redirection of this revenue and the process of horizontal fiscal equalisation and specific purpose payments add another layer of interaction between Australia's governments. The associated processes also influence the behaviour of the participants.

An alternative solution lies in governments cooperating to develop better governance arrangements since, for many areas of shared responsibility, it is neither practical or appropriate to cede responsibility entirely to one level of government. This approach recognises that shared responsibility was a deliberate design feature of Australia's Constitution rather than a design flaw (see, for example, Galligan 1995 and Walsh 1991). However, this inevitably gives rise to tensions about the appropriate form of these arrangements, including mechanisms for establishing clear policy strategies and setting priorities and the associated allocation of resources, assigning responsibility for policy implementation, resolving funding issues, and ensuring that effective performance monitoring arrangements are in place.

2.4 Looking to the future

The competitive and cooperative dimensions of our federal system will each continue to have a role to play in helping Australia successfully tackle some significant challenges that face it and, in the process, enable the nation to continue to improve its living standards.

The challenges ahead

Australia faces significant challenges in the years ahead associated with increasing globalisation, environmental sustainability and population ageing. While there is scope for competition between governments to help promote policy improvements and innovations in responding to these challenges, collective and cooperative action, especially on broad policy frameworks, will be particularly important because of the extensive cross-jurisdictional elements associated with each challenge.

Globalisation is increasing

Globalisation of trade and investment and with it the integration of the world's economies is increasing, with China and India emerging as major new players.

While this provides important new opportunities for Australia, it also heightens competitive pressures. Our future living standards will be shaped by how well we respond. Countries that are unable to respond efficiently, flexibly and innovatively to changing patterns of demand, technological change, increasing mobility of capital and labour and shifts in underlying comparative advantage, risk seeing their standards of living fall, at least in relative terms.

An obvious area for policy focus, in this context, is further reducing barriers to the movement of goods and people within Australia that are attributable to unwarranted variations in institutional or regulatory frameworks. While considerable progress has been made in lessening impediments to the development of national markets in several areas, it is also apparent that the reform task is far from complete. For example, considerable scope remains to integrate better much of our economic infrastructure, notably in the areas of energy, water and freight transport (PC 2005f). Invariably, such reform requires collective action by governments.

Environmental sustainability

Environmental sustainability underpinned by effective natural resource management is integral to the living standards and quality of life of current and future generations.

As noted earlier, many of the policy issues associated with the effective management of natural resources and environmental systems involve cross-border considerations. Problems such as land degradation continue to be a drain on Australia's productive capacity, with a substantial commitment of resources and coordinated action between governments needed to enhance management and, where appropriate, rectify past mismanagement. Community demands to preserve biodiversity and enhance environmental amenity are becoming stronger. And, as in other countries, responding to greenhouse gas-related issues in the decades ahead could see significant adjustment challenges for domestic industries, particularly in regard to adaptation and technological innovation.

Population ageing

Arguably one of the biggest challenges facing Australia in the coming decades is the ageing of the population — as a consequence of falling fertility and, more importantly, of increasing life expectancy. The ageing phenomenon is not unique to Australia and brings important benefits. However, it will substantially increase demands for services such as health and aged care while significantly reducing the potential labour supply relative to the population. Projections by the Commission suggest that, in the absence of policy responses, this will in turn cut per capita

income growth by as much as a half by the mid-2020s compared to its 2003-04 growth rate (PC 2005c).

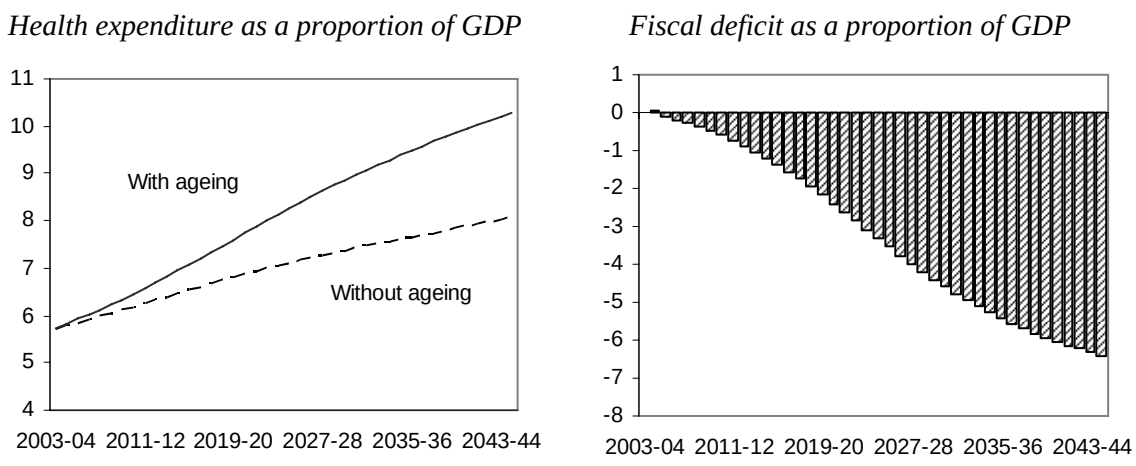
The most significant sources of potential stress on government budgets are health and aged care, with the former contributing most to the expected increase in government outlays. Health care costs are projected to rise by about 4.5 percentage points of GDP by 2044-45, with ageing accounting for nearly one-half of the increase, or some $40 billion of extra spending (figure 2.1).

Overall, the fiscal gap associated with spending and revenue trends, in the absence of policy responses, is projected to be around 6.5 per cent of GDP by 2044-45, with ageing accounting for almost 90 per cent of the gap. On past trends, much of the fiscal burden could be expected to be borne by the Australian Government, but there are significant potential burdens faced by State and Territory Governments.

A range of policy measures will be required to reduce the fiscal pressures of ageing or to finance the fiscal gap. Measures to raise productivity and labour force participation would lift income growth and the community's capacity to pay for the costs of ageing. Beyond this, more cost-effective delivery of government services, especially health care, would alleviate a major source of fiscal pressure at its source. While some policy measures can be effectively pursued on a jurisdictional basis, many will require collective and coordinated action across jurisdictions. For example, many potential reforms in the health and aged care areas require a multi-jurisdictional approach.

Figure 2.1 **Projected impacts of ageing on health expenditure and fiscal pressure**

Share of GDP, per cent



Data source: PC (2005c).

Responding to these challenges

To meet these challenges and to improve standards of living generally, Australia will need to position itself to maintain or improve its productivity performance of the past decade.

Australia's economic performance since the early-1990s stands out, not only by historical standards, but also among OECD countries. Even so, our economy is still characterised by inefficiencies and performance gaps which indicate that we have some way to go to realise our productivity potential. In terms of GDP per hour worked, we achieved 81 per cent of the US level in 2004 — only slightly above where we were in 1950. Productivity growth is a fundamental determinant of future living standards. If Australia could achieve the same productivity levels as the US — still below the world's highest levels — gross average household income could be 20 per cent, or some $22 000 a year higher.

Whether or not matching US levels of productivity is realistic, the benefits for Australia of realising our productivity potential would be substantial and accumulate over time. Indeed, if Australia could sustain even half the improvement in the rate of productivity growth achieved during the 1990s, real cumulative GDP from 2003-04 to 2044-45 would be some $2000 billion higher than if average productivity growth rates slipped back to the levels of the preceding two decades, resulting in GDP per capita in 2044-45 being around 6 per cent higher than otherwise (PC 2005f).

The Commission's research (PC 2005c, 2005f), as well as other recent studies (Access Economics 2005; Bracks 2005), suggest that there is considerable scope to achieve a more productive and sustainable Australia by building, in particular, on recent interjurisdictional reform initiatives in areas like NCP and embracing further reform in areas such as social infrastructure, natural resource management, labour markets, taxation and wider regulatory processes. Such a broad reform agenda involves all levels of government. While it provides opportunities for independent initiatives by individual governments, capturing the potential benefits in many areas will require further nationally coordinated reform.

In relation to opportunities for further nationally coordinated reform linked to the CoAG Review of NCP, the Heads of Government at the June 2005 CoAG meeting agreed:

> While the benefits of NCP reforms are significant, gains from a broader economic reform agenda have the capacity to deliver much more to the community. Collaborative action on issues of national importance is again required, as a fragmented reform agenda will not achieve the momentum and commitment required for sustainable reform. … The case for continuing reforms on a collaborative basis is clear. (CoAG 2005, pp. 4, 5)

CoAG agreed to proceed with the NCP Review, drawing on the Commission's report on the *Review of National Competition Policy Reforms* (PC 2005f) as part of the process. The senior officials undertaking the Review are to report to CoAG by the end of 2005.

The agenda is wide ranging

A summary of the forward agenda for national reform recently proposed by the Commission is presented in box 2.7.

The proposed agenda is broad and challenging. It extends beyond purely economic issues, involving well-established pro-competitive prescriptions, to areas with important social and environmental dimensions.

That said, significant parts of the forward agenda are largely continuations of, or extensions to, NCP. As such, they can be accommodated within existing institutional frameworks, drawing on established reform principles and processes. In several key areas, much of what is required to deliver better outcomes has been set up already. Consequently, implementing the additional reforms proposed for, say, energy and water should not involve major new work for CoAG.

In contrast, more detailed work supported by independent public reviews will be required in several areas as a pre-requisite to effective reform initiatives. This approach recognises that, in the past, progress with more complex reforms, requiring joint government agreement, has typically been facilitated by public reviews. This aids the process of reform by allowing for the clarification of the nature and extent of the problems, an assessment of the most beneficial reform measures and the development of an effective implementation strategy and timetable. Consistent with this, the Commission has proposed that there be independent public reviews for four areas within the forward agenda — health care, freight transport, natural resource management and consumer protection policies.

For health care — the area judged to offer the largest potential benefits from nationally coordinated reform — the Commission has proposed a review covering all dimensions of the health care system. Such a review would have a particular emphasis on the development of options to clarify government roles and responsibilities and associated funding arrangements, and to ensure effective coordination across individual service areas, including with aged care services.

Box 2.7 **Summary of the forward agenda proposed by the Productivity Commission as part of its review of NCP**

- In a number of key reform areas, national coordination will be critical to good outcomes. These areas — many of which have been encompassed by NCP — should be brought together in a new reform program with common governance and monitoring arrangements. Priorities for the program include:
  - strengthening the operation of the national electricity market;
  - enhancing water allocation and trading regimes and to better address scarcity and negative environmental impacts;
  - delivering a more efficient and integrated freight transport system;
  - addressing uncertainty and policy fragmentation in relation to greenhouse gas abatement policies;
  - improving the effectiveness and efficiency of consumer protection policies; and
  - introducing a more targeted legislation review mechanism, while strengthening arrangements to screen any new legislative restrictions on competition.
- An 'overarching' policy review of the entire health system should be the first step in developing a nationally coordinated reform program to address problems that are inflating costs, reducing service quality and limiting access to services.
- National action is also needed to re-energise reform in the vocational education and training area.
- Identifying areas of natural resource management (beyond water and greenhouse gases) where the pay-offs from new nationally coordinated reform could be high and what is required to reap the gains, should be the subject of a future review.

Source: PC (2005f).

At its June 2005 meeting, CoAG recognised that many Australians (including the elderly and disabled) experience difficulties at the interfaces of different parts of the health system. It was also agreed that the system could be improved by clarifying the roles and responsibilities of governments, and by reducing duplication and gaps in services. Senior Officials have been tasked with developing an action plan to improve the health system and are to report back to CoAG in December 2005 (CoAG 2005, pp. 2–3). This 'review', which is sponsored by CoAG, lacks public involvement and has comparatively limited terms of reference. Nevertheless, in drawing on recent examinations of the health sector in some jurisdictions, the work of the Health Reform Task Force and the findings from the Commission's current examination of health workforce issues for CoAG, the review offers an opportunity to identify useful national reforms.

Decisions in relation to the other proposed reviews and the wider reform agenda advanced by the Commission are expected following completion, later this year, of the CoAG review of NCP.

Future reform initiatives will need to range more widely than the forward agenda flagged in box 2.7, which focuses on areas where there would be a high pay-off from nationally coordinated approaches. Other important areas for policy attention include labour market arrangements, taxation and the efficient development of our cities and regions.

Notwithstanding considerable reform to labour market arrangements over the last two decades, some significant restrictions on competition and flexibility remain. Further, differences in State and Territory provisions, and their interface with federal arrangements, can create significant complications for, and impose substantial costs on, multistate employers.

The Australian Government is moving to establish a national system to govern workplace relations, based on the corporations power in the Constitution. Depending on the estimates used, this would bring some 85 to 90 per cent of employees into a single market system (Andrews 2005). Another mechanism for advancing workplace relations reform nationally could entail the development of a national alternative operating in parallel to the existing State systems, enabling employers to opt out if they chose. In advancing this approach, as part of its *Review of National Competition Policy Reforms*, the Commission acknowledged that balancing the costs of divergent approaches to labour market reform against the potential benefits of interjurisdictional competition was not easy, and that the efficacy of such an arrangement would depend on the detail (PC 2005f).

Most of the issues in the taxation and urban planning/regional development areas are primarily for individual jurisdictions to resolve. For example, a key reform issue in the taxation area — the interface between the taxation regime and social security support and its implications for labour force participation rates — lies largely within the province of the Australian Government.

Both competition and cooperation are needed

Looking ahead, the competitive dimension of Australia's federal system will continue to provide in-built incentives for each government to undertake reforms to improve public sector efficiency and to enhance the regulatory and institutional frameworks within which citizens and businesses operate. Beyond this, Australia's experience with NCP demonstrates that effective cooperation among jurisdictions in

achieving reform can yield further significant dividends to the community (PC 2005f).

Securing these dividends will require strong leadership from CoAG and other national leadership bodies. The experience of NCP also demonstrates the importance of governments establishing robust institutional arrangements to support future reform initiatives. Such arrangements need to:

- spell out objectives and principles to underpin reform programs;
- facilitate the analysis required to develop well-founded specific reform options and to provide for public input to that process;
- provide for independent monitoring of progress in implementing changes according to agreed timetables; and
- embody mechanisms to lock in the gains of past reforms and prevent backsliding.

Given the scope for lifting the performance of the economy and the need to respond pro-actively to looming challenges, the potential pay-offs from 'getting it right' are likely to be large.

3 Competitive federalism — wasteful or welfare enhancing?

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3.1 Introduction: perspectives on federalism

Discussions about key features and outcomes of Australia's federal system of government frequently employ language which suggests that, if not positively dysfunctional, the relationships necessarily involved frequently create distortions that lead to avoidable 'waste and inefficiency'. While perspectives about how the federal system actually works that underpin these sorts of conclusions vary significantly, and sometimes are inconsistent, there are some common elements. I pick-out just a few that are particularly pertinent to my subsequent analysis of 'competitive federalism'.

Australia's Constitution, it frequently is suggested, mandates an *excessive degree of 'concurrence'* in the powers and functions of the Australian Government and the States, leading to *wasteful overlap and duplication, and cost and blame shifting*, as a result of competition between the Australian Government and the States in jointly-occupied fields. This is argued to be compounded, moreover, by the Australian Government using its 'grants power' to provide specific purpose (tied) payments to the States which *impose excessively detailed and distorting conditions* on how the States exercise even their (constitutionally) exclusive functions.

The *exceptionally high degree of 'vertical fiscal imbalance'* (VFI) exhibited by Australia's federal fiscal arrangements, it also often is implied, has been created through *coercive* exercise of the Australian Government's powers, and the resulting *dependence* of the States on grants to fund their core functions is argued to be a source of *irresponsibility and inefficiency in decision making* by the States. The fact that the Australian Government distributes these grants between the States

according to a formula designed to achieve 'horizontal fiscal equalisation' (HFE) frequently is said to *add to the distorting effects of untied grants* overall.

In addition to the undesirable consequences of features of 'vertical' relationships between the Australian Government and the States, there are at least equally undesirable consequences of competitive behaviour by the States in their own domains, it is suggested. *Parochialism* frequently is identified as a characteristic of States' behaviour in, for example, setting regulations and in negotiating 'nationally desirable' changes to them. Competition between the States, moreover — especially for the location of firms — often is characterised as *wasteful*, leading in some cases, it is claimed, to *beggar-thy-neighbour strategies* that reduce national productivity and wellbeing.

Looked at through the lens of these sorts of depictions of the operation and outcomes of federal-state (intergovernmental) and State-State (interjurisdictional) interrelationships, it seems clear that the predominant view(s) about Australia's federal system characterise it as involving a mixture of coercion and rivalry, both of which are viewed as involving undesirable behaviour by governments at both levels more-or-less systemically. Although opinions differ about whether, or to what extent, the Australian Government should have a dominant capacity to 'shape' decisions that influence the outcomes, there appears to be a consensus — sometimes implicit, but often explicit — that a 'more cooperative' system of both intergovernmental and interstate relationships would be desirable.

I doubt that there is any analyst or observer of Australia's federal system who would deny, a priori, that a greater degree of cooperation might be desirable — and possible — 'in the national interest' in some areas of intergovernmental and interjurisdictional relations. I do not intend to be an exception. I do, however, intend to dispute the proposition that either coercion or wasteful competition are the most useful depictions of how Australia's federal system actually works. I also intend to dispute the proposition that cooperation would be a preferred overarching 'organising principle' for the conduct of political relationships in federal systems.

What I intend to argue, in fact, is that:

- *competition* between governments in federal systems — rather than coercion or unbounded rivalry — best explains what we actually observe;
- substantial amounts of *cooperation* will exist even in intensely competitive intergovernmental and interjurisdictional relationships; and
- overall, competition, not cooperation, is the preferred *organising principle* for federal relationships.

From this perspective, so-called overlap and duplication is, often, a desirable consequence of political competition and so, too, are VFI, HFE and even interstate rivalry.

To make my argument, I need to explain what I mean by political competition in general, and in federal systems in particular, and also to provide an analysis of how it works and what its outcomes are likely to be.

3.2 Politics and policy in federal systems

Those who have contributed to the literature on 'the economic theory of politics' have developed varied views about political processes and their implications for public policy outcomes. The models and the assumptions that drive them are too many and varied to be easily summarised, but I think it would be fair to say that, on the whole, they do not create great optimism about the likelihood of political outcomes being even approximately efficient in addressing market failures. In particular, important as they may be in ensuring that citizen-voter preferences have at least some sway, and in legitimising the use of the power of the state, if competition between political parties through elections is taken as virtually the only mechanism through which decisions about the supply of public sector policies are driven, the relationship between supply and electorate preferences is likely to be, at best, weak. There needs to be a much richer set of avenues through which competition or other constraints operate on the supply side to close the gap between supply decisions and citizen-voter preferences.

Going beyond this to federal aspects of political systems, to a very significant extent what economists who have studied the economics of federalism have had to say about federalism is disjoint, in two senses. First, while federal systems often have been argued to add greater competition, and hence more constraints to the potential divergence between the supply of, and demand for, public policies than in unitary (and especially unitary parliamentary) systems, the connections made with other dimensions of economic theories of democracy often are weak or non-existent. Second, the federalism literature has tended to develop mainly around normative models (for example, of the desirable 'division' of functions, or the appropriate role of intergovernmental grants) and in an *ad hoc*, issue-by-issue, way. All that notwithstanding, I think it would be fair to say that there has been increasing acceptance, among economists (and, to a degree, political scientists) that the competition introduced by federal governmental systems, for the most part, is likely to drive better outcomes for citizen-voters than unitary alternatives.

Intragovernmental political competition

Building on 'models' of governmental systems that have been in development since the mid-1960s, Albert Breton (1996), in a book entitled *Competitive Governments: An Economic Theory of Politics and Public Finance*, presents a new way of thinking about models of political competition. It would be too much of a distraction to fully lay out Breton's arguments, but, since I borrow from them, I need to provide a brief summary.

In essence, Breton argues that political competition, even in unitary systems of government, is much richer than usually portrayed in the economics of politics literature. This is because there are potentially large numbers of both autonomous centres of power (political parties and High Courts) and semi, or quasi, autonomous centres of power (for example, courts at various levels, intelligence agencies, police, tribunals, commissions, public corporations, advisory councils, central banks and so on) within the public sector, all driven by self interest to want to influence public sector outcomes. Since the relevance and legitimacy (and hence the capacity to have an effective influence on supply) of each and all of these power centres derives from them winning political consent, they are all driven by competition for consent to reshape potential outcomes in ways that reflect the preferences of citizen-voters for goods and services supplied by the public sector.

Thus, Breton suggests, political competition (even in parliamentary systems of (democratic) government) drives outcomes more responsive to citizen-voter preferences than is usually assumed or derived from models which focus essentially on inter-party competition. In fact, Breton goes further, suggesting that there is a tendency for something approximating efficiency in supply to be produced (in the sense that citizen-voters will face tax prices approximating the marginal benefits they receive), although he acknowledges some potential blockages to full achievement of efficiency (for example, principal-agent problems with respect to bureaucratic influences on outcomes).

One does not have to go all-the-way with Breton's claims to acknowledge his point that intragovernmental competition is likely to be more vibrant, and hence more constraining, than often is assumed, and that significant unfilled opportunities to provide goods and services through the public sector more in line with at least some citizen-voters' preferences are likely to stimulate supply-responses from one or another source. These ultimately get reflected explicitly or implicitly in policy platforms, but it is not elections alone that explain what is in the platforms. And, if this is so, it is so within *all* spheres of elected governments in federal (and multi-level) systems of government. It also will lead to stronger competition *between*

governments, vertically and horizontally, than if competition *within* governments was less vibrant.

Intergovernmental and interjurisdictional political competition

With this as a broad background, I now begin to approach intergovernmental competition more directly. As will become clear, while the phrase 'competitive federalism' probably most commonly is thought of (by economists at least) as being horizontal — that is, interstate or interjurisdictional — I devote a fair proportion of my discussion to vertical (federal-state or intergovernmental) competition, for reasons that will become clear as I proceed.

Although the analysis I offer has applications to all (democratic) multi-level systems of government, I stick to a *strictly* federal context. I do this not only because it is Australia's reality but also because a constitutional entrenchment of powers creates a significantly different 'dynamic' than one where powers are delegated to lower levels by a central government. That is, while constitutional provisions may act to constrain or restrict possible outcomes of political competition in federal systems, the fact that powers are, within bounds, 'owned' also prevents the outcomes of competition from being determined by unilaterally imposed changes to the division of powers and functions, or even just by unilateral abrogation of agreements and understandings, as they can be, in principle at least, in unitary systems. This is not to say that the substance of constitutionally defined powers is invariant, but rather that what changes occur do so principally through agreed self-regulating, processes, or through negotiation.

The fact that the principal focus of attention in this paper is on (democratic) federal systems makes elements of language important. In particular, reference to 'levels' of government is inappropriate, or at least needs to be interpreted with due care. Constitutional powers are both divided between (broadly speaking) equals and also shared between them. My preferred language would refer to national and state governments as occupying 'spheres', which can intersect — that is, overlap — or not as circumstances dictate. I will, however, often slip and slide between references to 'spheres' and 'levels' as best facilitates simplicity and clarity of expression. I hope that this will not lead to erroneous impressions of my intended meaning.

However one conceptualises the significance of intersecting national and state powers and responsibilities, they exist and their presence both promotes and reflects intergovernmental (vertical) and interjurisdictional (horizontal) political competition. How political competition manifests itself, however — whether within governments or between them — often is significantly different

(descriptively and analytically) from the notion of price competition that dominates much of conventional/mainstream economics. As many analysts have observed, building on earlier contributions by Joseph Schumpeter (1934, 1942), political competition is intensely rivalrous, and often involves building support around unifying slogans. In the broad, it is suggested, political competition is more akin to Schumpeterian 'entrepreneurial competition' than simple price competition, with innovation, and its adoption and adaption, occurring both in service delivery *per se* and in the creation and promotion of unifying symbols or images of the society in which they will be delivered or to which they will contribute.

The goods and services offered by the public sector, moreover, can range from intrinsically private (for example, dental treatment) with or without subsidies, to inherently public (defence, or macroeconomic management), with distributional objectives and outcomes also on offer. Even where 'price' is a key factor in the supply/demand equation, it may be as much reflected in tax structures as in tax rates.

The only limit on what the public sector can be conceived as supplying is that anything that the public sector does supply must reflect, to some extent, the actual preferences of citizen-voters. Among other things, this would explain why State and Local Governments undertake overtly redistributional functions, despite a substantial economics literature that says they should not or, if they do, likely will have their intentions frustrated. It also explains why we see unambiguously 'demand management' strategies being applied by sub-national governments, again despite a literature that says it is likely to be to a degree futile.

Governments at all levels are responding to voter preferences for all sorts of goods and services, of which 'local' redistribution and 'local' demand management are two among many. They may well find that it pays them to cooperate with other governments to minimise 'costs', but they cannot abandon the field without suffering significant potential political damage. Regulations, for my purposes, also can be conceived as being a 'good' — or, perhaps more appropriately, a service — supplied by governments in addition to the usual array, ranging from defence and foreign affairs, through health and education, to roads and garbage collection.

These observations about politics and policy in federal systems underpin what I have to say about all aspects of political competition. I turn, first, to 'vertical' competition.

3.3 Vertical (intergovernmental) competition

There has been relatively little *systematic* discussion in the literature on the economics of federalism of vertical — that is, federal-state or intergovernmental — competition. This is not to say that there has been none. There is, for example, a substantial literature on tax harmonisation between federal and state spheres, though its ultimate thrust arguably is to seek ways of minimising both vertical and horizontal tax competition. There also is a very substantial literature on so-called VFI and its counterpart in intergovernmental grants, though for the most part it is normative and, implicitly or explicitly, assumes that vertical relationships are dominated by coercive powers presumed to be possessed by federal governments. And, when it comes to analysing policies in particular functional areas (health, education, transport or whatever), it is more often than not assumed or asserted that where there are overlapping federal and state policies and programs (surely a manifestation of vertical competition), blurring of responsibilities is likely to result in waste and inefficiency.

In what follows, I attempt to tease out the logic of some of these views, in particular the misplaced, as I see it, idea that overlapping powers and responsibilities are a systemic source of inefficiency.

Undesirable overlap and duplication? Or what?

Normative and positive approaches

I do not think it would be unfair to suggest that among economists (and many students of political science, public administration and sometimes constitutional law) 'fuzziness' in the constitutional distribution of functions between spheres of government is seen as a defect that should be minimised, if not by constitutional change then at least by political and administrative agreements and arrangements. For economists, this line of thought flows from at least two directions, one of which is unambiguously normative and the other more positive/empirical.

The normative basis lies in the economic theory of (fiscal) federalism, which sees functions as desirably and/or appropriately allocated:

- *to* governments only to the extent that they involve the supply of goods and services that exhibit 'public goods' characteristics and/or the correction of externalities/spillovers; and
- *between* spheres of government according to the spatial distribution of the 'publicness' or spillover effects of public sector goods and services.

Taken to its logical limits, this would seem to lead to a presumption in favour of a higgledy-piggledy 'structure' of more or less 'special purpose' governments of varying geographical spread, some of which might enter into mutually-agreed contractual arrangements where there are economies of scale or scope in production (as opposed to provision).

In practice, while different countries have varying structures of governments, the dominant model for elected governments is the familiar hierarchy of local/plus regional or state/plus national, and fiscal federalism theory reconciles this with the differences in the spatial distribution of benefits by recommending that a system of tied grants be used to ensure that spill-ins or spill-outs of benefits or costs between jurisdictions are appropriately taken into account.

The other line of reasoning simply argues that where two or more jurisdictions have overlapping functions, essentially competing bureaucracies and decision-making processes are created, the costs of which are avoidable if roles and responsibilities were more tightly defined, or at least minimised if greater cooperation and coordination was practiced.

What does the Constitution say?

On either or both of these accounts, not only is Australia's Constitution flawed but so, too, is the behaviour of governments within the constitutional framework that they operate in. Since no one can seriously entertain the likelihood of significant constitutional change in Australia, precisely what it does and does not empower governments to do may not appear, at first sight, to be the most salient of issues in thinking about how to facilitate welfare-enhancing outcomes. It is, however, worth summarising in relation to issues pertinent to the overlap and duplication issue.

The first thing to be said in our context is that powers and functions which are not specifically assigned in Australia's Constitution ('residual' powers, as constitutional lawyers would refer to them) reside with the States, as is true also in the USA but not, for example, in Canada. Or, to turn the point on its head, the Australian Constitution gives the Australian Government very few *exclusive* powers — that is, that it alone can exercise: imposing duties of customs and excise, issuing money and raising a naval or military force, are perhaps the most relevant exclusive Australian Government powers in the current context.

Section 51 of the Constitution defines the broadest set of the Australian Government's functional powers — and, importantly, it does so as *concurrent* with those of the States, subject only to the provision that the Australian Government's powers are paramount (that is, where there is conflict between Federal and State

legislation, the Australian Government's legislation 'wins'). So, even in the case of defence or foreign affairs or pensions, the Australian Government in effect 'shares' its powers with the States. Needless to say, in this and in many other areas of concurrent jurisdiction, Australian Government legislation and political and administrative processes have ensured that it, by and large, 'occupies (much of, if not all of) the field'. But in some, there are implied limits on Australian Government power — over corporations, and over labour market relations (conciliation and arbitration), for example — where only 'interstate' dimensions fall under unambiguous Australian Government powers and where the Australian Government has been able to exercise relatively unfettered power only by gaining agreement of the High Court or by encouraging and 'accepting' State references of power.

What are notably missing from the Australian Government's capacity to 'override' the States' legislative and administrative powers within their own jurisdictions are the areas of health, education, transport other than railways, and law and order. The Constitution gives no direct (exclusive or concurrent) power to the Australian Government in these functional areas. What it does do, however, is give the Australian Government power to provide grants to the States 'on such terms and conditions as the Parliament shall see fit'. This power has been used — some would say abused — in many contexts, including (since the end of World War II) to ensure that State Governments do not impose income taxes on their residents. However, it also gives the Australian Government power to engage with the States in the provision of goods and services where the Australian Government believes that there is a case for doing so that it cannot achieve through its explicit powers under Section 51 of the Constitution or otherwise.

So what, you might ask? So the Constitution not only mandates overlapping powers, it also facilitates them, I'd say in response. Although much has changed, technologically, economically and politically, since the writing of the Australian Constitution, there is little doubt that the Founders knew what they were doing — that is, attempting to achieve the benefits of an economic and political union, while also 'constraining' the power of the central government that was being created, including by overtly putting it into competition with the States.

I would also say, however, that had the Constitution been designed differently — with, say, a neater and tidier specification of formal powers, there would nonetheless have been *a tendency* for the pattern of what governments in different spheres actually do to become fuzzier over time — that is, for there to be *de facto* concurrency. This follows more or less directly from the fact that there is competition between spheres of government (that is, vertical or intergovernmental competition) as well as within any given sphere (horizontal competition). The

formal division of powers in the Constitution may shape and constrain the outcomes of vertical competition, but they do not extinguish it.

Sources and nature of vertical competition

Most of the discussion and analysis of competition in federal systems has focused on horizontal competition. This is so for perhaps a number of reasons. Firstly, there is often a mindset that sees, or wants to see, federal systems as involving 'dual' or 'layer-cake' powers, with governments at different levels (desirably) doing essentially separated things, with only unavoidable spillover effects requiring any significant interactions. Secondly, another, while accepting that overlaps in powers and functions are inevitable, wants to see them as almost invariably necessitating and leading to intergovernmental cooperation. Both of these are, ultimately, views about how observers think federal systems *ought to* operate and, to a significant extent, reflect the fact that what we actually observe on the whole is not either dual or cooperative but rather is competitive.

A third reason, applicable especially to economists, is that it is easy to see that mobility — actual or potential — can drive horizontal political competition, but less easy to specify and model how competition works vertically. We obviously see manifestations of vertical competition all around us — as with the current contest between the Australian Government and the States over workplace relations legislation, the outcome of which is yet to be determined. The question is whether this competition is a manifestation of, say, capture of the Australian Government's agenda by powerful interests, with long-run outcomes likely to be determined ultimately more by the limits of the Australian Government's power, than by whether it is responsive to underlying preferences of citizen-voters.

Albert Breton, adopting a framework developed by Pierre Salmon (1987a, 1987b), suggests that at least one mechanism which ensures that intergovernmental (vertical) competition exists is, in effect, benchmarking by citizen-voters and opposition parties. That is, citizen-voters, at least to some extent, use information they acquire about one or more 'benchmark' governments to assess the performance of their own government(s) in the supply of goods and services, including regulations and the like. Opposition parties have access to the same information (and possibly more) and so potentially have 'ready-made' platforms on which to compete against governing parties at each level. On this account, the contest for political support (or consent) within jurisdictions at each 'level' also induces competition between governments at different levels.

The question then is — does vertical competition in federal systems result in an appropriate ('efficient') occupation of functions?

I do not think it is asking too much to suggest that there will be forces that *tend* to promote efficiency, rather than its opposite. That is, there is a reasonable *a priori* presumption that there will be a tendency for activities to be 'sorted' between spheres of government in ways which minimise the costs of provision — *and* that if this is precluded by constitutional provisions, there will be pressures to seek changes to those provisions or ways around them.

A full depiction of what both efficient and actual outcomes would look like is beyond the scope of this paper, including because it is dependent not only on the basic nature of the goods and services concerned and the technology of their production, but also on a variety of other costs that need to be taken into account, not least the costs of signalling, of coordination, of administration and of contract negotiation and enforcement. A couple of general points are worth making, however, relating to the allocation of functions and centralising tax collection.

Allocation of functions between governments

Other things equal, a competitive 'sorting' process would tend to lead *activities* with significant scale economies to be produced at higher levels of government and those with predominantly diseconomies of scale at lower levels. This is not only because of the underlying production technologies, but also because of the costs of coordination among 'lower' levels of government to achieve scale economies not available to them separately and the costs of coordination, administration and monitoring to higher levels of government in efficiently providing goods and services subject to predominantly diseconomies of scale. Similar observations could apply with respect to activities likely to stimulate more, or less, mobility and/or spillover effects, whether on the benefit or revenue-raising side.

Because there is a tendency to think about governments fulfilling 'functions', it would be easy to slip into thinking of this discussion as being about how functions will tend to be competitively sorted — that is, divided. The reality is that all things that are appropriately categorised as policy functions — health, education, welfare, defence, law and order, labour markets, environment, agriculture and many more — involve collections of activities with quite different shaped cost functions and, correspondingly, different spheres of government are likely to have a comparative advantage in providing the different activities, even allowing for the possible gains to them from coordination with other governments up or down the production chain. So, for example, in welfare policy 'activities' range from setting tax and cash benefit structures through labour market training programs to the provision of public housing or of shelter for homeless persons.

In short, vertical competition — even mediated by the potential political pay-offs from various forms of coordination, contracting and sub-contracting, and so on required to reflect interdependencies, including complementarities and spillovers — will almost invariably result in significant functional overlap. Though I would not want to push it too far, taking into account the costs as well as the benefits of coordination, the sorting of activities between government that emerges may appropriately internalise most, if not all, of the interdependencies that arise, at least if one treats grants as part of the supply-mix.

Looked at from the broad perspective offered above, it seems plausible to argue, for example, that the Whitlam experiment of competing with the States in relation to urban and regional development, welfare, hospitals and so on was a failure not so much because it offended the States' views of their rights (as powerful an organising symbol as that *sometimes* might be), but because it projected the Australian Government into activities in which they suffered significant cost disadvantages, relative to the States, including both coordination and contract enforcement costs. It would also provide at least part of the reason why the Australian Government is not interested in offers by some States to hand over their public hospitals.

On the other hand, the current projection by the Australian Government into what otherwise would be State legislative and policing activities in the interests of meeting counter terrorism needs, probably reflects not only Australian Government perspectives on national policy needs and State acquiescence in the face of public concerns, but also the cost advantages the Australian Government possesses in gathering and interpreting intelligence, in coordinating surveillance and police actions across State boundaries and so on. Less clear-cut are examples such as the Australian Government's entry into the provision of (a limited number of) secondary technical colleges across the States, even though it is clearly complementary with Australian Government initiatives to increase labour market participation and skills development. Perhaps it is a wedge to try to gain greater leverage over the vocational education and training sector than it has achieved in the past?

Vertical fiscal imbalance

The second general point to be made about likely outcomes of vertical competition is that what — often pejoratively, including by me (see, for example, Walsh 1991) — is referred to as VFI is as likely to be the outcome of rational (and efficient) intergovernmental agreements — sometimes explicit and sometimes implicit — as of the exercise of 'coercive' powers of central governments. There have been numerous responses to assertions that VFI is a source of distortion and inefficiency

(see, among others, Brennan and Pincus 1996). However, Albert Breton (1996, ch. 8) has offered the most comprehensive analysis to date. I aim to do no more than draw on two or three elements of his analysis pertinent to my discussion.

The starting point is the observation that there are potentially significant economies of scale available in centralising tax collection. These arise not only from economies in tax administration, but also because, for example, the potential evasion and avoidance associated with mobility of tax bases when taxes are imposed and administered at lower levels of government is reduced. Other things equal, tax rates could be lower for any given required revenue with centralisation, generating potential mutual benefits to both higher and lower level jurisdictions. There is, thus, an incentive for lower-level jurisdictions to delegate tax collection on their behalf to higher-level jurisdictions, and for higher-level jurisdictions to accept that delegation, where the scale and nature of the tax base warrant it.

However, centralisation of tax collection and the degree of harmonisation of definitions of bases, tax rate structures and so on that it requires, involves costs. Some are associated with coordination *per se*. Others involve, for example, a loss of capacity for lower levels of governments to compete with others at the same level, which will be greater for jurisdictions which see themselves as having a comparative revenue-raising advantage. So, on grounds of costs associated with centralisation, this form of negotiated centralisation may not occur at all (for example, if the numbers of lower level jurisdictions that need to agree are large) or, may not be complete (that is, some jurisdictions may choose not to participate while others do).

If tax collection arrangements of this sort arise, then VFI will exist *by mutual agreement*: the tax collecting government will raise more revenue than it spends on its own purposes and vice versa for the recipient governments. Moreover, the revenue transfers (‘grants’) from higher to lower levels of government may be — again by mutual agreement — a mixture of untied (unconditional) revenue sharing grants and tied (conditional, or specific purpose) grants.

To ensure that the tax collecting government (the agent) does not allow the benefits of joint collection to be eroded through inefficient tax collection — the presence or absence of which is costly to monitor by the recipient governments (the principals) — there must be a clear and continuing stream of benefits to the collecting agent from minimising inefficiency. Some of those benefits will flow to the collecting government from its share of the economies of scale from centralised tax collection that create the potential for mutual benefits in the first place, and to that extent pure revenue sharing will be mutually beneficial and acceptable. But once, for a given joint tax rate schedule, the revenue ‘needs’ of the tax collecting government are met, any further tax revenue collection on behalf of

lower level governments would have to be purchased by them by offering altogether other political benefits to the higher level government.

A fortiori, the additional revenue transfers would have to be 'tied', and tied to the delivery of goods and services in the supply of which the lower level governments have a competitive advantage (otherwise the central government could be better off by spending on them — supplying them — on its own account). There also must be a high level of visibility for the central government's contributions, a verifiably high level of demand for the goods and services among citizen-voters and a verifiable set of implicit or explicit performance 'benchmarks' to be met, to ensure that adequate political benefits flow to the grant-giving government. What functional areas, and activities in them, might meet these requirements is likely to change over time, although it seems *a priori* obvious that education, health, roads and transport, training and the like would qualify in current circumstances. Importantly, moreover, on this line of reasoning, opportunities for tied grants are, in effect, as much supplied by lower level government as demanded by upper levels, and the conditions negotiated rather than imposed. Nonetheless, tensions would be likely to arise when, for example, perceptions about pay-offs from established grant patterns and conditions change.

This line of reasoning is highly suggestive and, in a number of respects, leaves significant parts of the literature on VFI and intergovernmental grants looking decidedly shaky. Its potential explanatory power in various federal systems on the face of it might seem highly variable. For example, it fits well with Canada's Tax Collection Agreements and Established Programs grants — including the partial and total opt-outs by some provinces — and also with the relatively much more autarchic US federal fiscal system, with a much larger number of State and Local Governments. In Germany, and more so Australia, one would have to rely on a more supply-side driven story, and enrichments driven by, for example, judicial interpretations. Indeed, one would expect history and culture as well as constitutions and their interpretations to restrain or redirect what emerges and how.

Vertical competition and efficient outcomes

For present purposes, the central message has two parts:

- the first, is that vertical competition between governments in federal systems is not necessarily, or inherently, 'conflictual': cooperation and coordination can lie behind what superficially may appear to be coercive outcomes, a fact sometimes reflected in observations about the 'theatre' of intergovernmental relations; and

- the second goes back to the theme of so-called overlap and duplication: the specific purpose grants that are often portrayed as the Australian Government more or less unilaterally intruding into State responsibilities and, in the process, creating more undesirable overlap and duplication *might* actually be a reflection of other mutually beneficial federal-state (at least implicit) bargains, and more sought than imposed.

This *is not* to say anything like 'always and everywhere' or 'inevitably' but, along with the earlier discussion about competitive supply of activities, it *is* to say that there are forces at work that have the potential to push the outcomes of federal-state fiscal interactions more forcefully towards 'efficient' outcomes than often is assumed or conceded.

At the very least, the standard presumption that 'overlapping' of powers, responsibilities, functions or activities on either the supply or the financing side signal a high probability of significant waste and inefficiency is open to dispute. As long as governments at different 'levels' are obliged to compete with one another to sustain political consent, and ultimately power, not only will functional overlaps be the norm — even in foreign relations and defence, for example — but also some incentives will exist for seeking out lower-cost ways of delivering outputs and outcomes including, where necessary, by seeking to improve coordination between levels of government. If this was not so, it would be hard to explain why Prime Ministers and Premiers have jointly invested time, energy and political capital in CoAG meetings and the processes associated with them, including the plethora of Ministerial councils, over at least the last 15 years. It would be equally hard to explain why the Australian Government would be motivated to concede to the States the totality of revenues from the GST — a tax the States could not impose in their own right.

Of course, there is no guarantee that the outcomes of intergovernmental political competition always will be 'permitted' to even converge towards as fully efficient outcomes as can be envisaged because the formal constitutional division of powers constrains or precludes (that is, prohibitively raises the cost of) achievement of them. If so, and the potential benefits foregone are sufficiently large, pressures can be expected to build to seek to remove the blockage — if not by constitutional change, by encouraging judicial reinterpretation or by negotiating alternatives (for example, referral of State powers to the Australian Government, as has happened with Corporations Law; or by the Australian Government acting for the States where they are precluded, as happened when the High Court, in effect, ruled State Franchise Fees to be duties of excise and, arguably, has been amplified through the GST Intergovernmental Agreement).

The difficulties and uncertainties associated with such 'adjustment processes' involve costs — at least of the 'a benefit deferred is a benefit reduced' variety — that are more easily avoidable in, say, unitary systems. But they protect outcomes against the potential for capriciousness and coercion: 'mutuality' of benefits from *de jure* or *de facto* changes to constitutional assignments of power are required.

What price cooperative federalism?

The broad thrust of my argument to this point is that intergovernmental (that is, 'vertical') relations are essentially competitive. As a consequence, the overlap and duplication which typically is argued to be, more often than not, a source of waste and inefficiency in the delivery of goods and services by the public sector is not only facilitated by the constitutional division and sharing of powers but would, in effect, be created if it was not already there. This is so because the competition for political support or consent will tend to drive governments to sort themselves across activities — within and between functions — in ways which reflect their competitive advantages — that is, to where they can produce goods and services at least cost, taking into account not only production technologies, but also the costs of coordination, administration contracting and signalling. Where the results of the sorting involve complementarities or spillovers between the activities of different governments, there will be a tendency for cooperative/coordinated responses where they can produce a mutual net reduction in costs.

I also argue that, on the revenue-raising and financing side, too, there will be incentives for a degree of revenue-raising specialisation — usually, if it exists, in the form of some degree of centralisation of tax collection, with transfers — grants — reflecting the (at least implicit) role of the central government in collecting revenue on behalf of lower levels of government. On this account, tied grants, rather than being unwanted intrusions into State functions and responsibilities, may be as much, if not more, a refection of the lower level governments offering opportunities to their revenue collecting agent as a desire by the central government to intrude into the supply of activities that they otherwise could not compete in.

This is obviously a very optimistic rendition of the potential outcomes of competitive intergovernmental relations. Even if one accepts the underlying hypothesis — that is, that not only *are* intergovernmental relations competitive but also that such competition will, on the whole, tend to push outcomes towards the promotion of efficiency in the supply of goods and services by governments — it is possible to argue that, as presented here — necessarily briefly — it implies an excessive degree of determinism; it does not adequately reflect the role of, for example, history, culture, ideology and jurisprudence; and that, faced with changes

in the external environment, including changes in available supply technologies, adjustments may be undesirably slow. I would be prepared to plead guilty, but only to a lesser charge and argue extenuating circumstances. That is, I have wanted to pose a challenge to what has been, in Australia as elsewhere, the dominant theory of intergovernmental relations — namely, the theory of cooperative federalism. Actually, it seems to me that as a *description* of how intergovernmental relations work, the notion of cooperative federalism is not without a degree of substance. That is, even if you see intergovernmental relations as being completely 'driven' by political competition, you would expect to see a fairly high degree of cooperation — or, more precisely, coordination — because it can reduce the costs of supplying goods and services to citizen-voters (or its dual, expand the capacity to supply them), and political competition will drive governments to want to do so.

Benefits and costs of cooperation

This sort of coordination happens in private markets — as when, for example, firms outsource the supply of services to reduce costs. In the sphere of intergovernmental relations it is sometimes considerably more overt — managing complementarities and interdependencies, or reaping the potential mutual benefits of exploiting economies of scale, often requires what are comparatively high profile negotiations and formal intergovernmental agreements. The long-standing series of Commonwealth–State Housing Agreements, CoAG and Ministerial Council processes, the Intergovernmental Agreement on the GST and, arguably, even the old Premiers' Conferences, in principle, can be seen in this light. The fact that getting there *appears* 'conflictual', disharmonious, even rancorous, and that outcomes are described as wins or losses does not invariably mean that a zero-sum game has been played out. Of course, it could, or there may be asymmetrical information or power that loads the dice — presumably largely in the Australian Government's favour. But if that were so, it is hard to see why the Australian Government would give the States a so-called 'growth tax', or at least, it requires a convoluted argument to characterise this as 'coercive'.

Whichever way one interprets this evidence of apparent cooperation, it is hard to leap from there to the normative proposition that cooperative federalism would be the preferred organising principle for intergovernmental relations. If what cooperation (coordination) we observe is largely zero sum, with the Australian Government almost invariably the winner, advocating *more* cooperation would seem to be a recipe for (more rapidly) increasing centralisation of power. On the other hand, if the cooperation we observe is primarily of the positive sum sort that is, in effect, a (desirable) consequence of the two spheres of government competing for political support within their own spheres, you might, logically, argue that there are revealed inadequacies in dealing with interdependencies which

greater information, new ideas and so on could help to fix. But, first, these need to be addressed on a case-by-case basis rather than being seen as indicators of systemic failures of competitive federalism. And, second, it is also appropriate to acknowledge that the failures are revealed by the competitive process itself (for example, the consequences for public hospitals of an inadequate supply of supported accommodation for the frail elderly) — that is, there are potentially valuable insights to be lost by (attempting) to more or less systematically reduce intergovernmental competition.

Ultimately, the case against cooperation as *the* central organising principle for intergovernmental relations is both that it almost certainly is costly — coordination imposes significant costs in time, effort and money that is diverted from productive activity — and also it has the potential to end up being essentially secretive and coercive. Like for cartels in the private sector, the 'customers' interests, though not entirely overlooked, are diluted. Even a seemingly simple outcome like cooperatively eliminating overlaps by reassigning activities or boundaries between them can both increase supply costs and leave some citizen-voters falling through cracks in the supply menu. The constitutional division of powers, interpretation by the High Court, and intra- and inter-party competition in both spheres of government, among other things, would likely limit the risks of systemic collusion of this sort — aided and abetted, no doubt by shifts in the prevailing intellectual orthodoxy. Even in the United States, where cooperative federalism initially developed among political scientists as a response to the apparent consequences of the previous conception of federalism as dual or coordinate, the potential virtues of competitive federalism — vertical as well as horizontal have been increasingly recognised in recent years.

In my view, competitive intergovernmental relations are *not inherently* a source of waste and inefficiency; they do not *block* coordination and cooperation where it is mutually beneficial; and so-called overlap and duplication may, as often as not, be a sign of the intergovernmental system functioning relatively well — that is, in the interests of citizen-voters. There may be (numerous) examples of apparent 'political failure', but they are unlikely to be systemic, at least in the sense that the costs of doing something about them — for example, through increased coordination, or redefining boundaries or whatever — will invariably be worth their cost. This is not to say that there are not many good ideas about workable and worthwhile reforms. But to get recognised, I believe, they need to be sold on a case-by-case basis as solutions to particular problems, rather than under a catch-all slogan.

3.4 Horizontal (interjurisdictional) competition

The fact that there is substantial 'horizontal'— that is, interjurisdictional — competition in federal systems has been much more widely acknowledged and, equally importantly, analysed in the public sector economics literature than has its 'vertical' counterpart. This is so, I suggest, for a number of more or less obvious reasons.

- The first is conceptual. That is, it is virtually impossible to treat the relationship *between* the States — unlike that between the Australian Government and the States — as being essentially about the exercise of (relative) political power and hence pretty much beyond the scope of conventional economic analysis: in the Australian Constitution (at least after the transition period), the States have equal powers exercisable only within their own jurisdiction(s) and the Senate, with equal representation for all the States, was conceived as limiting the indirect use of political power by the more populous States through their larger numbers in the House of Representatives.
- The second is that there is at least one seemingly obvious mechanism through which interjurisdictional political competition can be effected — by seeking to influence the locational decisions of households and/or of physical and financial capital.

As a source of competition, however, mobility has both been questioned as to its relevance and, at the same time, been argued to be a source of waste and inefficiency. In what follows, I examine the nature and consequences of interstate competition, and what can be done, if necessary, to limit any potentially damaging consequences.

The nature and consequences of horizontal competition

Unlike with vertical — intergovernmental — competition which is often characterised as more a contest for power than a mechanism for promoting wellbeing, no-one I know doubts that horizontal — interjurisdictional or interstate — competition exists and has *the potential* to promote the welfare or wellbeing of citizen-voters. The contentious issue is whether it does promote wellbeing — or, perhaps, whether it does so to the greatest feasible extent — and whether there is anything that can be done to reduce its vices.

Mobility of citizen-voters

The idea that, in federal systems of government, citizens can vote 'with their feet' as well as 'through the ballot box' in response to the policies and programs offered by different sub-national governments has proved to be intuitively appealing. Whether actual or potential, mobility of citizen-voters is seen as providing a mechanism which justifies what otherwise would be purely an act of faith — that is, that sub-national governments are likely to be 'more responsive' than central governments — and which also supports the idea that federal systems have the potential to encourage policy and program innovations and their diffusion across jurisdictions.

In the economics of federalism literature, the role of mobility of citizen-voters as a source of interjurisdictional competition entered principally through Charles Tiebout's (1956) paper on the provision of local public goods. This spawned a substantial empirical and theoretical literature examining the efficiency consequences of mobility and desirable policy adjustments in its presence (such as tax harmonisation and fiscal equalisation). Rather than trawl through the results of various models and studies, it will be more productive for present purposes to more broadly examine how, and to what extent, mobility might promote and enhance efficient public sector outcomes.

It is important to emphasise that what is the focus of attention here is (potential) '*policy-induced' mobility* by households (ultimately citizen-voters). Many influences affect decisions to move, or not to do so. At different stages in their life, people may decide to move in spite of negative consequences in terms of the 'net public sector benefits' that they will receive and other costs they will incur: higher incomes, or improved lifestyles or stronger family connections, for example, may be dominant influences. Conversely, the opportunity to receive higher net public sector benefits by moving may be outweighed by, for example, the transactions costs of moving, or potential income reductions or the loss of family or community connections.

Empirical studies suggest that policy-induced mobility of households does exist but that it is modest compared to mobility induced by other location-specific influences. This result is not surprising — not only because other costs or benefits of moving between locations are substantial, but also because *potential* exit (or entry) is likely to operate as a significant constraint on the politically sustainable degree of policy divergence between jurisdictions. *Actual* policy-induced mobility by citizen-voters must reflect an unwillingness or inability of some jurisdictions to eliminate policy differences with other jurisdictions, or to do so 'sufficiently rapidly'. Unless preferences for public sector supplied goods and services differ

significantly and systematically between citizen-voters in different jurisdictions, *potential* mobility will be enough to result in 'interjurisdictional competition'.

In at least some expositions of the virtues of the capacity of citizens to 'vote by moving', mobility is treated more as a 'sorting device' than a source of political competition. That is, it is observed that, even if governments were not at all responsive to citizen-voter preferences (including the fact that voters might move to express them), mobility between jurisdictions gives citizen-voters a means for 'sorting themselves' according to which jurisdiction most nearly meets their preferences. This, self-evidently, is a story about mobility and public sector efficiency which effectively eliminates political competition altogether.

To turn potential mobility into a *driver* of interjurisdictional competition rather than a *response to a lack of it*, there has to be a link between policy-movement and people-movement (and vice versa). There clearly are many different ways of doing so, with different degrees of sophistication and relevance. One — somewhat simplistic — way of forging a link would be to postulate that there is, in some sense, an 'optimal population' for each jurisdiction — that is, say, a population which just balances the benefits of scale and scope in supplying and financing public sector supplied goods and services against increasing costs of congestion and/or diseconomies of administration and coordination associated with replicating optimal-sized facilities. Jurisdictions with 'below optimal' populations will compete to attract additional people and those with 'above optimal' populations will 'compete' to reduce them.

Exactly what form(s) political competition between jurisdictions might take can be many and varied, ranging from general tax and spending policies, through regulations affecting urban development, to 'business attraction' strategies. However while this 'model' introduces a stronger two-way link between mobility and jurisdictional policy settings, the objectives and outcomes of political competition are essentially deterministic — that is, driven by the technologies underlying public sector supply of goods and services. Also, importantly, there is no role for a major feature of political life — that is, *intra*jurisdictional political competition — which can be expected to be significant factor shaping policies which, in turn, influence mobility.

Interjurisdictional comparisons

One way of building a link between *inter* and *intra* jurisdictional competition is to consider the case of public sector policy and program innovation and its diffusion across jurisdictions. There is no doubt that we observe a significant amount of policy and program 'innovation' and its subsequent adoption or adaption in other

jurisdictions. Obvious examples include: the abandonment of death duties, initially in Queensland; the spread and fine-tuning of workers' compensation, and occupational health and safety legislation; the introduction of casemix funding for hospitals; the introduction of poker machines into pubs and clubs; the imposition of financial institutions duties; and the progressive banning of smoking in public places, including now in pubs and clubs.

As these examples suggest, the 'virtues' of such innovations sometimes can be open to debate. However, the fact that policy and program innovations do occur must be presumed to be a reflection of political competition for citizen-voter consent within the initiating jurisdiction(s), otherwise it would be difficult to explain why they occur. Their subsequent diffusion (or even the lack of it), moreover, must also be a reflection of political competition *within* other jurisdictions: governments, oppositions and other centres of power are, in effect, offered 'ready-made' platforms for generating increased consent by adopting or adapting innovations initiated elsewhere, if there are significant 'constituencies' for them.

Potential 'policy-induced' mobility — the threat of exit — *may* play a role in adoption or adaption of policy or program innovations by governments, if *actual* mobility is perceived to be a significant, politically disadvantageous, possibility. On this account, actual policy-induced mobility must be a consequence of a judgement by governments that the political costs of attempting to prevent it are greater than those of not doing so. But — and this represents an important departure from the conventional analysis of how *inter*jursidictional competition is motivated (see Breton 1996, and also Salmon 1987a, 1987b) — it is not potential mobility *per se* that creates interjurisdictional competition.

As a matter of logic, if 'policy-induced' mobility of households (as citizen-voters, among other things) even *potentially* exists, it must be that citizen-voters are able and motivated to compare (something like) the different 'net policy benefit' that they can expect to receive in alternative jurisdictions, and to act on them. This is not to say that comprehensive information and a refined calculus is required: broad-brushed information about relative tax burdens, and indicators of the quality of services for which people have relatively intense preferences, would do. But it is to say that, seen in this way — as surely it must be — it is *not* mobility that is the source of interjurisdictional competition. Interjurisdictional comparisons — *benchmarking* — are the *source*, and mobility is, at most, one *potential consequence* of political competition generated by benchmarking.

How much information citizen-voters have, and the quality and reliability of it, is important to the consequences of benchmarking, of course. But they only shape its potency, not its existence. Casual information from friends or from travel

experiences; media reports, with or without backing from formal evaluation processes; access to official statistics and reports on policies and programs; and information campaigns, funded and/or motivated by governments and other centres of power, all feed benchmarking processes.

From a conceptual/theoretical viewpoint, what this implies is that benchmarking as a source of interjurisdictional competition is not *distinct from* and additional to mobility as a source of interjurisdictional competition which can 'take over' when mobility is weak or non-existent. Benchmarking does not *displace* policy-induced mobility. Rather it *explains it*, where it exists, and it, equally importantly, promotes other responses to 'policy differences' where they exist, even where mobility is not likely, or relevant.

Ultimately, what the recognition of the essential role of 'benchmarking' does is to entrench explanations of the causes and consequences of *inter*jurisdictional competition very firmly into the analysis of *intra*jurisdictional competition. The information available to citizen-voters that enables them to benchmark their government's performance is available to opposition parties and other centres of power, all of which have an incentive to use it to their maximum advantage in competing for political support/consent. And this pressures governments to respond competitively. It may sometimes be the case that what results is policies and programs that are distorting — catering to the special interests of sub-groups of jurisdictions' populations — but this seems unlikely to be the typical outcome. In general, intrajurisdictional competition and its interjurisdictional counterpart is likely to generate outcomes for households — that is, citizen-voters — that are broadly efficient, being responsive to citizen-voter preferences. Where interjurisdictional competition is likely to be (often?) distorting is where it involves such things as rivalry to attract businesses, special events and the like which are likely to be much more footloose than households.

Interstate rivalry

As noted earlier, households may not be very mobile in response to differences in the provision and financing of goods and services by State Governments, but physical and even more so financial capital surely are. If they were not, it would be hard to provide a rational explanation of the panoply of inducements offered to attract (or retain) firms and, where necessary, appropriately skilled labour — for example, cash and in kind subsidies, tax concessions or holidays, loan guarantees, public sector procurement preferences, skills training programs and much more (see IC 1996, for an 'exposé' in Australia, and; Kenyon and Kincaid 1991, for the United States). They occur not only at State level but in various forms at local government level. These overt mechanisms are not the only things used, of course.

Many others are not so selective or exclusive — such as provision or subsidisation of sports arenas; festivals and other events, museums, swimming pools, transport routes — but still to an extent beyond merely 'getting the basics right' (though there is widespread recognition that without the high quality education and health services and the like, the cost of attracting business through concessions will rise).

Although, at one level, these phenomena simply reflect the fact that there is interjurisdictional political competition, and that it is often 'vibrant', they are more often referred to as examples of 'interstate rivalry', in a pejorative sense. That is, the competition is argued to be distorting even in the winning State, because it usually is selective, and if it is not pointless (that is, buying firms that would have come or stayed anyway) it is inevitably distorting nationally (and even internationally). The costs to budgets, moreover, are greater than those incurred by the 'winning' State — the losers have put in time, effort and money, too. There is, also, often a lack of public accountability, with the nature of the deal and its costs held to be commercial-in-confidence, as too can be the nature of benchmarks (for example, jobs or exports created) and progress actually made. I could say much more, but the central point is that such deals are seen as typically being at best zero sum from a national perspective and generally negative sum.

I do not intend to take issue with the broad thrust of these arguments. I do, however, want to add a caveat or two before turning to questions about how to limit potentially damaging competition of this sort.

The first point to be made is that in a national (more so than in an international) context, this rivalry probably is self-limiting. Players, more so winners, suffer budget costs. Even for the winners, the pay-back period is likely to be fairly lengthy — beyond a single electoral cycle — and for the losers it involves a fully sunk cost. So there are at least some consequences seen by some or all players as avoidable and a corresponding incentive to bargain — that is, use diplomacy — at least beyond some point, to limit further costs. (Even in the international context, not all tariff wars and competitive exchange rate depreciations proved unstable.) If there is not interstate diplomacy brought to bear (as there has been recently between all States except Queensland) there is some prospect of the Australian Government entering as an umpire. Whether these agreements are stable, however, is a question to be returned to.

The second point is that there usually is more than one avenue through which rivalrous competition can occur, and closing one avenue likely will increase the apparent value of others. So, even if one could devise an enforceable or self-enforcing agreement to close-off unmediated competition for business to relocate, competitive forces may intensify through, for example, bidding for Australian Government contracts or grants and the like.

The third point is that such selective competition is not always as damaging as is assumed. Some might be, at least in part, about correcting market failures: for example, by promoting R&D as a complement to national governments' strategies, or subsidising tourism promotion because of free-rider problems in especially generic but also destination promotional spending. And it is clearly less damaging when it uses unemployed resources — for example, in depressed regions — especially if mobility is limited.

In fact, it is possible to construct various cases in which what appears to be rivalrous behaviour of this type is nationally welfare enhancing. To give an oversimplified example, suppose that population levels in all but one State are optimal, in the sense that economies of scale in service provision are just offset by the potential diseconomies of congestion or coordination. The other State, however, has a population larger than optimal. Then it might be rational for that State, and for the nation as a whole, for it to promote industry attraction if doing so results in it being able to get nearer to an optimal outcome. (This *might* explain, for example, why Queensland has been a hang-out from the agreement between the other States to limit competitive industry attraction). Conversely, selective strategies might slow inefficient out-migration from States suffering temporary economic stresses and the like.

A fourth point is that we do not, as a rule, see the equivalent of 'bad money driving out good'. That is, this sort of competitive behaviour typically exists *alongside* welfare enhancing forms of competition — for example, leading to reductions in State Payroll Tax rates, or adoption of innovations on the service delivery side.

Constraining interstate rivalry

Australian Government activities

To minimise the damage from interstate rivalry, it commonly is argued that encouragement should be given to the development of interstate agreements, perhaps preferably with the Australian Government playing a role in facilitating and monitoring them. It is worth observing, first, that if it potentially can be in the Australian Government's interest to get involved, we should expect to find evidence that it does, indeed, already do so in some form or another, at least from time-to-time.

One form in which it clearly does is through specific or general support for 'regional development'. A recent specific example is in South Australia, where the Australian Government voluntarily entered into an agreement with the South

Australian Government to support absorption of the 'shock' caused by the announcement by Mitsubishi that it was significantly downsizing its operations. The agreement involves support for relocation and retraining of displaced workers as well as a coordinated strategy to attract new business, especially if they would utilise sunk investments in a no longer needed foundry.

More generally, Australian Governments of all persuasions have instituted programs supporting regional development agencies, including through subsidising the organisations *per se* and making grants available, often on a competitive basis, for specific investments, including training programs.

Of course, some of this Australian Government activity may reflect elements of pork-barrel politics. However, it is plausible to argue — as Albert Breton does — that at least some of it is implicitly or explicitly about restraining the need for more overt or aggressive interstate rivalry.

Another form in which it might be argued that the Australian Government seeks to moderate inefficient interstate competition is by reducing the disadvantages some economically and fiscally weaker States face that might lead to instability in the federal system — including sometimes more aggressive strategies by the weaker States to improve their positions — is through HFE. It is clear in Australia that the constitutional founders hoped that federation would lead to convergence in the economic fortunes and capacities of the States, but they also put in place mechanisms by which this could be aided, including that the Australian Government could, if it saw fit, discriminate among the States through grant giving (but not taxation). The history of what we now call fiscal equalisation in Australia in fact revolves around stresses created by the relative economic and fiscal incapacities at various stages of some States vis-à-vis others (see Walsh et al. 1993). This in turn eventually led to the establishment of the Commonwealth Grants Commission in the 1930s.

Although in the mainstream literature (see, for an extensive survey, Courchene 1984), the case for fiscal equalisation has been made on grounds of equity and efficiency (limiting inefficient migration), not only does the practice in Australia and elsewhere precede the development of the literature, it also fails to follow (or be revised to follow) the implications of the academic literature — namely that interpersonal transfers are required. As Courchene (1984) argued, and Walsh et al. (1993) reaffirmed, it is hard not to see fiscal equalisation as it is practised in fact reflecting essentially political motives — including there being broad acceptance by 'donor' States (most of the time and/or to some extent) that equalising transfers are necessary for the stability of the federation.

On this argument, as Breton also has suggested, fiscal equalisation may well be part of a collection of national government strategies aimed at maintaining the stability of the federal system, including by seeking to reduce the potential virulence or ferocity of rivalry that would come from weaker States having disadvantages in their capacities to respond to various means by which political competition regularly asserts itself. Though not definitive, it is at least highly suggestive and could help explain also why, for example, the EU uses structural and other funds to support weaker members (see Walsh et al. 1993).

Additional approaches

There doubtless are many other ways in which 'stability' is woven into the fabric of intergovernmental and interjurisdictional relationships. But, even on the most favourable interpretation, they do not make a case for believing that all rivalrous behaviour we see either is, in fact, welfare enhancing or is as constrained as the costs of doing something about it would imply is 'optimally inefficient'. The conventional response is to suggest that cooperative agreements between the States — especially in Australia, given that they are few — may at least sometimes be possible. The relatively recent agreement between most States is testimony to the potential mutual benefits. However, the standard problems with cooperative agreements clearly apply — each participant retains an incentive to chisel on the deal, especially where 'verification' of whether participants are meeting the terms of the agreement is difficult. And some potential participants may see a significant cost in joining — or significant benefit from holding out — unless a substantial *quid pro quo* is paid.

Agreements to have an independent monitor review the performance of participants might overcome some of the problems, but requires that participants are willing to agree to allow their behaviour to be continually assessed. The Government Services Provision reviews undertaken under the chairpersonship of the Productivity Commission may form the basis of a potential model, but the States may have much bigger gains from shared learning about their comparative performance in service delivery than in putting themselves under the microscope on assistance to industry. The participation by the States in a one-off review of these matters by the former Industry Commission (IC 1996) reflected the circumstances of the time. The failure to adopt the recommendation of a recurring assessment perhaps speaks for itself.

The obvious alternative to hoping for stable, self-enforcing interstate agreements would be to have CoAG establish such a process. Logic suggests that this has only as much of a chance of occurring as would an interstate agreement, unless the way was oiled by the Australian Government being willing to 'compensate' (that is,

'bribe') the States for their agreement to be in it. The prospects of that happening are unclear. The Intergovernmental Agreement on the GST is an example of where competitive inefficiencies in State tax systems were negotiated away, but it was a once-in-a-lifetime opportunity, the outcomes of which, moreover, were easy to monitor by the Australian Government.

Although I would not want to push it too far, in the end it may be that interstate competition to attract industry is sufficiently constrained in one way or another, for much of the time, to not be significantly in need of any more concerted action. Or, to put it another way, it may take an outburst of seriously damaging competition to result in it having a chance of becoming a serious topic for the CoAG process. Whether similar comments would or may apply to other sources of instability in interstate competition — such as where policy diffusion leads to the widespread adoption of what, from a national perspective are inefficiencies (or 'bads' more generally), or where migration from one State becomes self-reinforcing — would need more detailed analysis than I can offer here. However, much of the analysis in the past has overlooked the role of 'built-in' political stabilizers: once they are included, a less pessimistic frame of mind is possible.

Finally, although I stand to be possibly corrected by constitutional lawyers, there may be a provision of Australia's Constitution that could be utilised to strengthen the Australian Government's coordinating role in relation to State assistance to industry. That is, Section 101 provides that: 'There shall be an Inter-State Commission, with such powers of adjudication and administration as the Parliament deems necessary for the execution and maintenance, within the Commonwealth, of the provision of this Constitution relating to trade and commerce and of all laws made thereunder'. Whether and how such a Commission might be now established and operate would need to be considered. It may prove to be impossible to put into effect, or to work effectively. But it would seem worth some examination.

Interstate competition: the bottom line?

Unlike in the case of vertical competition, it is virtually impossible to think of horizontal competition in federal systems as being to any significant degree coercive, although it can be 'unbalanced' to the extent that some States face competitive disadvantages. Even among political scientists, particularly in recent years (see, for example, papers in Kenyon and Kincaid 1991) there has been an acceptance that some forms of interstate competition may be beneficial.

What I have suggested is that horizontal political competition must ultimately be explained by citizen-voters using some form of benchmarking of their State

Government against others, and that this is what, effectively, makes State Governments 'compete' with each other. The result of benchmarking may be to encourage the mobility that most frequently has been utilised to 'demonstrate' that there is competition but, if so, fiscally-induced mobility must be a signal that a State Government is unwilling or unable to match the performance of other governments where it is pertinent to the citizens of that State. That is, it is not mobility *per se* that drives the competition.

Policy innovation, and its adoption or adaption, or the lack of them, must ultimately be a cause as well as a consequence of interjurisdictional competition, and for the most part we can expect it to be beneficial — including, for example, discouraging State Governments from straying into supplying, on their own account, goods and services in the provision of which they have a competitive disadvantage. But it can lead to apparently inefficient outcomes — such as the diffusion, at least temporarily, of the use of undesirable tax bases (as, arguably, has occurred with poker machine taxes) or interstate rivalry in the attraction of business.

There are, nonetheless, I suggest, 'stabilisers' woven into the fabric of federal systems, including because national governments will have at least some incentives to ameliorate damaging rivalry. This is not to suggest that rivalry will be driven out of the system, but it does suggest that it is unlikely to be allowed to develop into a 'race-to-the-bottom' because both state and national governments have incentives to prevent it doing so. Interstate cooperation to limit mutually damaging behaviour may occur once the costs become too obvious or significant to ignore, but such agreements are not (easily made) self-enforcing. National governments may step in to seek to ameliorate (sufficiently) damaging rivalry or other forms of instability, but their capacity to do so depends on them being willing to induce or enforce interstate cooperation and on them having the capacity to monitor the terms of agreements.

As I argued was the case with vertical competition, horizontal competition will naturally give rise to various forms of cooperation and coordination — though in the horizontal case with the national (central) government sometimes as a facilitator or enforcer. As with vertical competition, however, cooperation as the *overall* organising principle for horizontal competition has little or no appeal: to the extent that it hinders productive competition, replacing it with restrictive (and often secret agreements) it would damage the capacity of intragovernmental competition to deliver efficient outcomes for citizen-voters.

3.5 Conclusions: competition or cooperation?

In this paper, I argue that common depictions both of how intergovernmental and interstate relations *actually* work — that is, as often involving coercion or wasteful competition, or both — and of how they *should* work — that is, predominantly through cooperation and collaboration between governments — are at least debatable, and possibly misconceived. Instead, I argue that all interjurisdictional relationships are most usefully conceived of as being competitive and that the competition involved (most) often will be *productive*, in the sense that it produces outcomes that are highly responsive to the preferences of citizen-voters.

Modelling intergovernmental and interjurisdictional relationships as being essentially competitive can explain much of what we see, moreover, including much of what often is left either unexplained but criticised as 'inefficient', or is explained by reference to inappropriate constitutional allocations of functions and/or the supposed coercive powers of central governments. Thus, for example:

- so-called overlap and duplication can be explained as the outcome of governments at national and state levels 'sorting themselves' between activities, within functional policy areas, according to which has a competitive (political) advantage in the delivery of those activities; and it can be expected often to also involve intergovernmental cooperation where complementarities or externalities exist between the activities that governments at different levels (efficiently) take on;
- vertical fiscal imbalance can be explained as being a result of mutually-beneficial agreements between national and state governments to centralise revenue-collection from at least some tax bases, and part of the resulting transfers of revenues to the States can be expected to typically involve tied grants — again, in effect, by mutual agreement; and
- horizontal fiscal equalisation (and other 'targeted' activities of national governments, such as regional development policies) can be explained as means by which national governments seek to 'stabilise' potential interjurisdictional rivalry to avoid it resulting in something like 'a race for the bottom'.

None of this is to say that 'competitive federalism' always will produce the feasible best outcomes. But it is to say that arguments that it fails to do so need to be established on a case-by-case basis, not as a general presumption. And it also is to say that those cases need to be established by reference to how best to meet the actual preferences and interests of citizen-voters, not the views of, for example, (even expert) 'ethical observers' or central agencies in various governments. Competitive governments (and oppositions) are not likely to be persuaded by

'good ideas' that leave them exposed to a diminution of the political consent ('support') they earn from citizen-voters.

There are, boiled down to the essentials, two ways in which my argument establishes both its positive and normative thrusts.

The first derives from the fact that interjurisdictional competition (vertical and horizontal) ultimately is driven by *intra*jurisdictional competition for citizen-voter political consent. This intrajurisdictional competition is more vigorous than often is assumed, because it involves many 'centres of power' — not just political parties — competing for citizen-voter consent. *Intra*jurisdictional competition leads to *inter*jurisdictional competition because citizen-voters benchmark their government(s) against one another and this, in turn, creates even more intense intrajurisdictional competition, driven by citizen-voter preferences. This does not preclude inefficient or wasteful outcomes, but it does suggest that they are not likely to be systemic, including because there will be 'stabilisers' in the system to limit potential 'excesses', and also because cooperation often will emerge where it is mutually beneficial.

The second relates to the idea that 'cooperative federalism' is to be preferred to 'competitive federalism'. Cooperation, as I have previously noted, is likely to be an actual outcome of *competitive* federalism where interdependencies result from the 'separate' decision making of governments about the activities they wish to undertake, and this sort of cooperation has mutual benefits (that is, it enhances the joint capacity of governments to win political consent). But as an 'organising principle' for interjurisdictional relationships (that is, a system which suppresses competition between governments on a more-or-less systematic basis), cooperation either is doomed to failure or can be dangerous.

It is doomed to failure if it does not produce outcomes which enhance the political competitiveness, (that is, among citizen-voters) of parties to it, and it is not obvious that it (invariably) will do so. In fact, what cooperative federalism usually is conceived of as producing is outcomes that make relationships between governments 'neater and tidier' or 'less rivalrous', or both. How these relate to what citizen-voters best will be served-by, or want, usually is not much explored or explained and, in fact, the conclusions can be positively antagonistic to 'responsiveness' (for example, by cutting off the capacity of citizen-voters to 'shop-around' to secure preferred outcomes).

Cooperative federalism also can be dangerous because, if it succeeds in establishing itself as the way that governments organise their interrelationships, it would free governments and their bureaucracies from the forces of political competition, enabling them to behave, in effect, like cartels in the private sector —

that is, promoting the interests of participants (governments and bureaucracies) at the expense of customers (citizen-voters). Executive, or elite, federalism are terms often used to describe the 'modes' of cooperative federalism, making their intentions or outcomes fairly transparent.

There is, of course, a risk of overstating the case for regarding competition in interjurisdictional relationships as resulting in 'efficient' rather than 'wasteful' outcomes. My central point is that many outcomes of federal relationships that are seen as indicators or sources of inefficiency may, in fact, be *desirable* outcomes of political competition — which, as we see around us, is capable of resulting in mutually beneficial cooperation.

Equivalent to 'market failures' in private markets, of course, there may be 'political failures'. But there are not compelling arguments for regarding them as essentially systemic; and, unlike with market failures, where political failures in interjurisdictional relationships can be convincingly demonstrated to exist, there cannot be an appeal, even conceptually, to an authority with unfettered power to correct them. The appropriate role of the independent analyst is to establish the case that there are alternative outcomes, and means for achieving them, that are mutually beneficial for governments driven by intrajurisdictional political competition for the consent of their citizen-voters. You do not have to be a believer in so-called 'States-rights' to accept that the will of 'the national majority' will not and should not always, win against the will of component 'State majorities'.

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Introduction

I certainly agree with one of the last points that Cliff Walsh made when he said that his was an optimistic paper. Cliff is entitled to be optimistic because he played a big role in the most important and partially successful attempt to clean up the institutions of Australian federal-state relations in the early-1990s. This attempt was ambitious at the time, with its aspirations for cleaning up fiscal arrangements as well for establishing a sound basis for what today has been called 'competitive federalism'. But the fiscal dimension of this attempt fell foul of the Paul Keating challenge to Bob Hawke, and we only got half of the reform. That half — National Competition Policy — was still a pretty good half.

The examples that both Jonathan Pincus and Cliff Walsh have given of successful cooperative federalism draw very heavily on that period of reform. Cliff at the time was still at the Centre of Federal Relations at the Australian National University. Jonathan is also very well qualified on this topic and it is good to have him looking at these issues from his new base at the Productivity Commission. These are both very interesting papers. They introduce many of the ideas that are important to analysis of the optimality of a federal system and of federal institutions, and, by implication, provide some grounds for assessment of the case for reform.

Productive reform in a federal system

Features of the Australian system

Jonathan tells us that Australia is in good company as a federal system. Federalism is not a majority form of governance but a common one. There are both advantages and disadvantages of federalism. Whatever advantages or disadvantages predominate, depends on the design features of the system and their implementation. Jonathan notes that Australia is distinctive amongst federations in a number of ways:

- for the extreme extent of vertical fiscal imbalance;
- for the extreme extent of overlapping functions (and he noted that this is continuing to expand); and
- for the extent of the efforts on intergovernmental cooperation.

Jonathan does not try to explain why Australian federalism is unusual in these ways. But probably all of these features of our federation are inter-related.

Horizontal fiscal equalisation in Australia

Jonathan also notes that our federation is extreme in the extent of horizontal fiscal equalisation (HFE). Vince FitzGerald and I observed in our report a few years ago (Garnaut and FitzGerald 2002), that this is surprising when, of all of the federations amongst developed countries — Germany, Canada, the United States — Australia starts with the least unequal distribution of income across States. Yet we do far more, and far more elaborately, to equalise. In fact, in the period when we were working on the report, I tried to find examples of other countries anywhere that have gone to similar lengths on equalisation. The only case that compared with it in ambition was the former Soviet Union, but in practice the former Soviet Union did not go as far as Australia.

Most of my detailed experience in the nitty gritty of fiscal federalism came in working with Vince. That was a rather intensive period of work. Anyone who has worked in public policy for a long time in Australia has run into issues of federal-state relations. For example, when I did a lot of work on resource taxation in the 1970s, I ran into questions of overlapping and competing jurisdictions in taxation. In any attempt to straighten these out, the main objective of the Western Australian Government was always to make sure that part of the straightening out was to exclude the new arrangements from the operations of the Commonwealth Grants Commission. That was much more important to the Western Australian Government than the taxation arrangements themselves, and quite rationally so, because what the State was left with depended mainly on what the Commonwealth Grants Commission did. The amount of mining revenues that was actually available to the State depended hardly at all on how much revenue was actually obtained from the resource projects. Every area of policy reform-delivery, delivery of services of all kinds, taxation in general and reform of the whole range of competition policy issues ends up depending on federal-state financial issues.

While noting the extreme extent of HFE in Australia, Jonathan does not say much about it beyond noting that it is so controversial that little has been done about it, except to try to simplify and render it more transparent. If attempts have been made to simplify it and make it more transparent, then I would have to say that they have been unsuccessful. The system has never been as opaque or as complicated as it is in 2005.

There is very little discussion of HFE in Jonathan's paper and little recognition of the need for reform. In reality, this important area of Australian public policy, is the

main exception to that great and far reaching period of reform — that I date from 1983 to 2000 — that set the scene for the big lift in Australian productivity growth in the 1990s. The reforms rose to a floodtide between 1988 and 1991, and the first attempts at fundamental federal-state reforms came out of that floodtide in the early-1990s.

The challenges ahead and who should do what

Jonathan is correct in emphasising that Australia needs continued growth in productivity. He is correct in saying that the stakes involved in our re-establishing the productivity growth of the 1990s are very high. We have lost that rapid productivity growth in recent years. We are going to need a lift again in productivity growth to be able to handle some of the great challenges facing us: the fiscal challenges of ageing, the hugely different competitive environment being created by rapid economic growth in some major developing countries — the issues that Jonathan drew attention to. He is correct in saying that success in the next wave of productivity raising reform is going to depend on the quality of federal-state relations. Virtually every item on his agenda of reform involves very large components of federal-state relations.

Jonathan's paper is sound in going through the basic economics of public finance and of the design of fiscal systems related to federal-state relations. He is correct in the emphasis he gives to the literature on the value of subsidiarity — each function is best done by the lowest level of government that, within reason, can do it. He is correct also on fiscal equivalence — the important economic advantages established in the public finance literature of having each level of government, to the greatest extent possible, raise the revenue that is necessary for funding its activities.

Cooperation and competition

But this sound analytic part of the paper is not brought to account in analysing what is actually going on in Australia. Perhaps a paper that is meant to set the scene for this meeting does not have to. But the rather eclectic treatment of some examples of competitive and cooperative federalism does not draw very systematically on the analytic framework that is presented. Jonathan's main organising idea in the body of the paper is the content of competitive and cooperative federalism. I think we can all agree on one point of optimism — that it is possible to get better welfare increasing outcomes through cooperation. We have seen that in the Australian federation. But what is unsaid and unanalysed is the extent of lost opportunity through weaknesses and failures.

A great deal is made of the distinction between productive and destructive competition. But not much is said in the way of defining what constitutes destructive and constructive competition. I would say much the same about the equivalent point in the Cliff Walsh paper, where it seems, at times, that destructive competition is where you do not like the results. You get that flavour about the question mark at the end of the death duties comment that Jonathan made. Jonathan asks us not to get hung up about overlap with vertical competition, that it may be beneficial. I think we can all agree that it may be beneficial in some circumstances, but it will be damaging in others. The important thing is to examine — first of all analytically and then with a careful eye to the empirical data — what the situation is in particular cases.

But one general point I would make is that it is very hard for electorates, or for commentators, or for anyone, to assess outcomes of competition when right at the centre of federal-state relations you have these huge transfers on the basis of principles that probably only a dozen people in Australia outside government understand. Apart from Vincent FitzGerald and I, that dozen comprises mainly of ex-government officials.

This reminds me of the discussion of protection and rural regulation in Australia in the 1960s and 1970s, or discussions today of social security or taxation. In all of these areas, to participate in the debate you have to be a professional. If you are not a full-time expert in the narrow field, you do not understand what is going on. It is not possible for even an interested scholar or journalist to get a very detailed appreciation of the transfers that are operating, the basis for them and whether they, on balance, are leading to a sound basis for competition between different States.

Jonathan and Cliff both endorse strongly yardstick competition as a dimension of horizontal competition between States. I would endorse that. But it is hard for yardstick competition to be effective if there is little understanding of the fiscal transfers that really are so important to establishing the playing field upon which the competition takes place. Yardstick competition in the tax area, for example, should be about whether one State does a better job of, at the margin, equating the costs of raising taxation with the benefits of expanding public services. But that margin is hugely different, depending on whether a State is a donor to the equalisation system or a recipient of it. So I think that the whole process of yardstick competition is affected, one could say distorted, by the underlying fiscal arrangement.

Concluding comment

So my general comment on Jonathan's paper is that it does a good job of introducing some of the important principles by which we can judge our federation,

but hardly starts at all on analysis of the actual quality of what is going on in our system — and it misses the thing that is rotten in the State of Denmark. The play that is being put on for us today by Jonathan and Cliff is Hamlet without the Prince of Denmark, or I suppose these days we would say, royalty without the Princess of Denmark. Cliff's paper takes a different approach, but there are some similarities to which I will refer.

Competitive federalism — wasteful or welfare enhancing?

Conventional wisdom

Cliff takes issue with a conventional wisdom of economists on federalism. That conventional wisdom includes a lot of the principles that Jonathan was articulating, although Jonathan later on made some recognition of some of the points that Cliff was making. The straw people — the straw economists with whom Cliff takes issue — are not very clearly defined, but the basic concepts that underlie the standard economic literature on federal systems and their optimality are challenged considerably. Cliff says that economists tend to be too sensitive to the perceived costs and too sceptical of the benefits of both competitive and cooperative federalism. That is very much his own judgment, based on experience that I respect, but from a different set of experiences I have formed a much less favourable view about how the system actually works.

The economists, Cliff says, are for an unattainable clarity in the definition of powers and roles, and a clarity which is, in any case, unnecessary. And Jonathan makes the good point that if you were really applying the concepts of public finance rigorously, then you would not have States providing each public service — you would have different units for different types of public servants. It is a good point and if there is too much divergence between the optimal area over which public goods are supplied and the boundaries of States, then I suppose there is something wrong with the boundaries of States. But, in Australia the geographic separation of States means that that issue probably is not quite as important as in a lot of federations.

Vertical fiscal imbalance

Like Jonathan, Cliff notes the economists' case against high levels of vertical fiscal imbalance (VFI), but he goes further than Jonathan in arguing that it does not matter. Both papers argue that it does not matter as much as the standard literature says, principally because there is an economic case for the central government

raising a lot of the taxation. I do not dispute the economic case for the central government receiving much of the revenue — and the case probably becomes stronger over time with greater mobility of capital and people. Nevertheless, the standard public finance critique of VFI remains valid. It may be efficient to raise more and more taxation at the centre, but there are economic costs and distortions in the federation from doing it. And it is best we understand those and put quite a lot of effort into designing distribution systems that minimise those effects.

Both papers, especially Cliff's, note that in collecting taxes centrally and redistributing them, the case can be made that there are benefits that can be seen in principal-agent terms — the Australian Government effectively acting as an agent for the State. There may be some difficulties with that if there is not scope for raising taxes at different rates in different States. There are even greater difficulties if the Australian Government is being seen as an agent — for example, in the collection of the GST — if the revenues are not going back to the States in which they are collected. You hear that it might be possible to think of the Australian Government as an agent of the States, but the linkage is broken once we get a huge Australian Government-controlled process of fiscal equalisation intervening between the collection of the revenue and its allocation.

Horizontal fiscal equalisation and destructive competition

Cliff says a bit more about HFE than Jonathan does. He makes an interesting point that in the literature there is a bit of a case made on economic grounds for HFE. I suppose that he is referring to Buchanan (1950) and the literature that grew out of that from the early-1950s. That is a case entirely in terms of wanting to avoid economically perverse migration towards States that are in a better position to provide good infrastructure. But then he notes two important things.

- One is that the Australian tendency to equalisation preceded the economic literature and was not based on that sort of rationale originally — although I would add that, in every decade since the 1950s, equalisation has gone a lot further. And it went a lot further again with the intergovernmental agreement of 2001, and was entrenched by the character of that intergovernmental agreement. So, although there was HFE before Buchanan, it was much less important in Australia. And it was much less important 20 years ago, or 10 years ago, than it is now.
- Cliff also notes, very importantly, that the assumptions upon which the Buchanan case for HFE are made are actually unimportant in practice in Australia. And he builds an alternative case for HFE that depends on establishing a rational basis for avoiding destructive competition in the provision of incentives for interstate movement of business and people.

I certainly buy the point that he makes about the assumptions of the Buchanan analysis not being of practical relevance to Australia. In fact, this whole area of Australian policy making in federal-state fiscal relations reminds me very much in many respects of the history of ideas in Australian policy making relating to the tariff. The Australian protection preceded the Stolper-Samuelson theorem, but once Stolper-Samuelson came out everyone seized upon it as a rationale for Australian protectionism — even though the specific assumptions in Samuelson's article bore no relation whatsoever to anything that was relevant in Australia. Much the same happened in the HFE area.

But let us examine Cliff's further point that, while there might not be a case — or a strong one — on the original theoretical grounds, there is a case in avoiding destructive competition that leads to distortion incentives for interstate migration. I think it was Cliff who mentioned that there is an interstate agreement, to which all States and Territories except Queensland are signatories, to constrain horizontal competition in a destructive way through offering anti-economic incentives for location of business activities.

In itself, that interstate agreement between seven States and Territories is encouraging. But the only place that really matters as a destination for intra-Australian migration, and where these destructive incentives seem to be quite important, is Queensland. And I think it is facile to deny that there is a sense in which incentives provided by Queensland are funded by the transfers from Victoria and New South Wales. So while in general one might make a case that interstate transfers can level the playing field for horizontal competition — and while HFE may help reduce unproductive migration between South Australia and New South Wales, or Western Australia and Victoria — in the one case that really matters on a large scale in Australia, the presence of the transfers under HFE seems to be one of the sources of destructive competition.

Distribution of functions between governments

Cliff notes that economists dislike concurrent powers, and that they would like something neater and tidier. Nevertheless, he notes that the fuzziness about responsibilities inherent in them is increasing over time and is a natural feature of the political process, and therefore must reflect something real in the preferences of the community. Jonathan makes a similar sort of point. I myself do not give a lot of weight to that argument that the fact that something exists means that there is a good rationale for it and an inevitability that it will continue to exist. After all, productivity-raising reform is all about challenging well established anti-productive institutions. That challenge must begin by defining through analysis what would be an optimal set of arrangements.

By definition, the official arrangements that are the goal of reform are contrary to what has come out of the Australian political process. Certainly, advocates of tariff reform in the 1960s, 1970s and early-1980s, or advocates of industrial relations reform at most times over the last 40 years, have been seen in their time as naive, just as advocates of fundamental reform of federal-state relations are now seen as being naive. They look naive because there were, and are, good political reasons why what exists exists. But, nevertheless, what exists was, and is, sub-optimal.

I agree with one element of Cliff's optimistic conclusion. I agree that Australia has shown that it can overcome some of the damaging features of its federal arrangements through cooperation. But that does not mean to say that everything that exists now is anything like optimal. And we are only going to get change if we put a large effort into defining optimal institutional arrangements, and then discussing them and educating the community until there is enough support for reform for political leaders to be prepared to take a risk. I think there are limits to the optimism one can have about reform in Australia without fundamental change in the fiscal heart of federal-state relations.

Problems with current fiscal arrangements

Horizontal fiscal equalisation

In the short time remaining, I will just list briefly, without explaining, a number of ways in which I think the current arrangements for HFE cut across the development of a rational basis for vertical and horizontal competition across jurisdictions in Australia — and cut across sound efforts for income maximising, welfare maximising, cooperation.

Firstly, the current arrangements are highly distortionary of the efforts of the central fiscal agencies in every government. To illustrate this, when Vince FitzGerald and I were working on our paper (Garnaut and FitzGerald 2002) there was a new Secretary of the Treasury appointed in the Northern Territory. The press release announcing the appointment, the Chief Minister's press release, gave as the sole qualification, 'this person is an expert in federal-state financial relations'. Well, that was quite appropriate, because the extent of the transfers to the Northern Territory are a far more important determinant of what goes on in the Northern Territory economy than anything the Northern Territory Government can do. This makes my point.

Secondly, the fact that the arrangements are so complicated, are a black box, means that they are understood by almost no one outside the governments who are

involved in the process of federal-state fiscal relations. This obscures all the important elements of democratic choice that underlie efficient vertical and horizontal competition.

Thirdly, the large transfers expand expenditure capacity in the recipient States, with two large and negative consequences for economic efficiency. It leads to an inefficient overall allocation of resources within those States and it distorts the political economy of the States. On the first point, the size of the public relative to the private sector in the recipient States is larger than would emerge from an official allocation of resources. On the second point, Vince and I noted that the proportion of the working aged population in Victoria in full-time private sector employment was one-third higher than in Tasmania, and the difference was, to a significant extent, the result of these huge transfers spent through the public sector. That shifted the whole political spectrum in Tasmania. People who, in Victoria, would be on one part of the spectrum, are in a different part in Tasmania because of this large artificial expansion of the public sector.

Specific purpose grants

I would like to make one last point on specific purpose grants. Both Cliff and Jonathan say that provision for these grants has been made in the Constitution, that they are a deliberate design feature of the Constitution so that they are not a flaw. In truth, specific purpose grants are now pervasive in Australia. There is a sense in which they have completely undermined the federal character of governance in Australia. There is hardly a single function now of a State Government, or hardly an important one, that does not receive some specific purpose grants, with conditions applied, from the Australian Government. This turns every State function into a concurrent function. That is one of the reasons why Australia is extreme in the extent to which this federation is dominated by concurrent powers.

There are lots of consequences from this that are damaging to economic efficiency. I will mention just one. It creates an opportunity for sectoral agencies in the Australian and State Governments to collude against reform, against the central agencies, at both state and federal level. If the Victorian Government wants to clean up some highly inefficient part of the medical sector, it will have to challenge the political economy reason why the inefficiency exists. If it wants to do that, it will be told by the health department in Victoria that you cannot change whatever it is that requires reform because Victoria's commitments and expenditures are locked into a federal-state agreement on specific purpose payments.

If there is any attempt by the Federal Treasury to work in favour of efficiency, in favour of reform, with the State Treasury, you will have very close cooperation

between the two health departments to ensure that neither the Federal Treasury nor the State Treasury gets a look in. There are some very important interactions between HFE and the specific purpose grants that I have not got time to go into, but which add to the inefficiency, the productivity-damaging character, of the specific purpose payments.

General discussion

The general discussion focused on Australian federal-state financial arrangements, covering how funds are collected and distributed to the States and Territories and how the associated mechanisms impact on incentives for reform. In addition, there were some comments on the allocation of roles and responsibilities between governments, as well as constitutional and political influences on reform.

Federal-state financial arrangements

The discussion revolved around the influence of federal-state financial arrangements on the incentives for State and Territory Governments to undertake productive reform.

Some distinct although overlapping issues were seen to be influencing these incentives:

- dividends from the reform process;
- vertical fiscal imbalance;
- horizontal fiscal equalisation; and
- specific purpose payments.

Reform dividends

One factor seen to be affecting incentives for reform at the State level is the adequacy of fiscal dividends from reform. It was argued by some participants that the fiscal benefits of reform undertaken by a State do not show up at the State level. Central to this argument is the contention that under current intergovernmental financial arrangements the full effects of an expansion of a State economy — whilst showing up in employment growth — do not flow back to the relevant State Government in terms of revenue growth. This adds to the challenges of pursuing reform as, even at the best of times, the reform process is made difficult by the lobbying of vested interests and resistance to change within government itself.

Views on the practical significance of this feature of Australia's intergovernmental financing arrangements differed. For example, one participant expressed

puzzlement at the supposed lack of a fiscal dividend by noting that as reform occurs there are benefits to both the Australian Government and the State treasuries — with the States getting their benefits largely through the disbursement of revenues from the goods and services tax (GST) — which is a 'growth' tax.

In this context, Cliff Walsh observed that because GST revenues are guaranteed to flow to the States, interstate reforms actually do provide a dividend, or at least a dividend that is shared between the States. However, another participant argued that income tax was the only real growth tax in Australia and that most of the fiscal dividend from efficiency-enhancing reforms has come through this tax base which does not form part of the revenue stream redistributed to the States and Territories.

Several participants noted that reform dividends comprised fiscal as well as non-fiscal elements. Related to this, in judging whether to pursue reforms, governments presumably took account of the overall benefits from these elements as well as the costs. In supporting this view, a participant said it was important for States to realise that they would be able to capture much of the economic and social dividends of reform, even if they experienced some leakage of the fiscal benefits to other jurisdictions, including the national government.

Vertical fiscal imbalance

One participant claimed that the very limited tax bases of the States seriously affected the benefits potentially available from the competitive dimension of our federal system. Moreover, it was argued that the tax bases of the States are narrowing and will narrow further over the next four or five years, so that they will be left with, essentially, payroll tax, land tax and stamp duty on homes as a residual tax base. In these circumstances, there would not be much by way of real competition in the raising of revenue and/or provision of services.

In contrast, another participant thought that vertical fiscal imbalance (VFI) had in-principle merit; that it made a lot of sense, for various reasons, to collect the majority of tax revenue at the federal level. However, in practice, it is doubtful whether the resulting VFI has been adequately addressed so that each level of government receives an appropriate distribution of resources to meet its expenditure responsibilities effectively.

The speakers and discussants took the opportunity to make some further comments in this area. Ross Garnaut indicated that he agreed with Jonathan Pincus and Cliff Walsh that the high degree of VFI in Australia had a sound rationale, especially with greater mobility of capital and labour. Walsh disputed the view that the scope for interjurisdictional competition was being lessened by a narrowing of the range

of State tax bases. He observed that payroll tax had been the predominant focus of attention of the States either in competing with one another or using it to attract particular investments in the past. At the margin, there remained scope to vary the level and structure of payroll tax, even though other taxes had disappeared. Pincus suggested that the States may not have used payroll tax effectively, and that they should change their approach if presented with another growth tax.

Horizontal fiscal equalisation

One participant argued that the incentive for a State to reform was also affected by the horizontal fiscal equalisation (HFE) process, especially where the affected State was a donor rather than a recipient under the process.

However, another participant disputed the idea that HFE, and the possibility of getting a smaller share of the equalisation grants, is a disincentive to undertaking reform in major infrastructure areas and developing a State's economy, claiming that it was irrelevant to government decision-making processes. 'It is a flea on the tail of the dog!'

Several participants supported the HFE concept. They maintained that HFE was, in effect, trying to promote government expenditure and service outcomes that would otherwise occur under a unitary system of government. Further, it was contended that many in the community support the notion of citizens having access to a range of services of given quality regardless of where they reside, and that required governments to have the capacity to deliver a consistent and standard level of service throughout each jurisdiction.

There was some discussion about the resource allocation and efficiency impacts of the transfers associated with HFE. One participant observed that it was very easy to overstate their significance. Although HFE may have some unfavourable impacts on efficiency and resource allocation across the economy, the redistribution involved for most States is not large. For example, as a proportion of the GST redistributed between the States, it is less than 10 per cent. Hence, while HFE involves costs, they need to be kept in perspective.

Against this, Ross Garnaut noted that some 20 per cent of the GST collected in NSW and Victoria goes to other States and that the redistributions were not a trivial matter for the recipient States. Nevertheless, Garnaut felt less emphasis needed to be placed on the transfers associated with HFE, which, while large, are not gargantuan, with more emphasis being placed on the dead weight costs. He characterised HFE as a large elaborate but non-transparent transfer process which distorted incentives for economising behaviour in all of the States, noting that he

and Vince FitzGerald had examined this area in some detail a few years previously (Garnaut and FitzGerald 2002). He observed that with a considerable degree of VFI being appropriate for Australia, it was important to develop a system of allocation that was economically efficient — with the point of departure being the allocation of 'property rights' to revenue to the States in which it is collected. Adjustments could then be made for objectively measured costs of small scale and for special circumstances of financial stress, the latter as in the original operation of the Grants Commission.

Jonathan Pincus commented that there was no case for embedding HFE in a constitution. He also remarked that the argument for HFE based on achieving what would happen under a unitary system is in trouble if a State decides not to spend the money on the basis that the Commonwealth Grants Commission has calculated. Specifically, there is a clash between the objective of equal outcomes for citizens and the objective of having States make their sovereign decisions. Cliff Walsh observed that there is often an acceptance of an intellectual case for having some form of fiscal equalisation. How it is practised seems to be a bigger issue than whether it should be there at all.

Specific purpose payments

Some participants were critical of the growing use and administration of specific purpose payments (SPPs). They pointed to their significance in areas such as health, aged care and community services and claimed that associated administrative arrangements were often inefficient and acted to limit the scope for States to usefully compete in the affected areas.

Discussion followed on whether the increasing use of SPPs was cooperative federalism in action or rather a sign of greater centralism. One participant dismissed the notion that SPPs had served as a vehicle for increased collaboration and cooperation between the States and the Australian Government. In his view, the States tended to sign up to SPP agreements somewhat reluctantly, often because they felt they had no choice if they were to fill the gap arising from VFI. Some concerns were also expressed about the conditions attached to SPPs and, in particular, their focus on input-related factors rather than outcomes.

Another participant suggested that while the 'best' SPPs were the Australian Government's contribution to joint funding in areas where there is a good deal of consultation and negotiation, many SPPs were indeed unilateral. Moreover, the increasing use of SPPs seemed to be at odds with the GST agreement whereby over time more money would go to the States, purportedly on an untied basis. One way to improve matters would be to dispense with SPPs in many of the 'less important'

areas and to concentrate on a more rational basis for allocating grants in the major areas of social policy — health, including aged care, and education and training — where the Australian Government makes a large financial contribution.

Who should do what?

One participant suggested that an important issue was the growing 'fuzziness' surrounding traditional functional responsibilities, due to greater complexity in society. Many people require a combination of 'human services', including health, aged care, disability services, housing services and other community services. The traditional ways of splitting up these areas between different levels of government does not yield good results. The participant contended that a different approach is required to the assignment of roles and responsibilities.

Another participant claimed that Australian governments have an 'absolutely crazy' sharing of responsibilities and duties — mainly due to the way the Constitution is cast. When it was drafted, areas such as health or aged care had a fairly unambiguous meaning, but this is no longer the case and what has emerged is not sensible and makes it difficult to achieve good outcomes.

The Constitution and political influences on reform

Several participants emphasised that Australia had been able to pursue considerable cross-jurisdictional reform over time — including via the national competition policy framework. This demonstrated a capacity to apply and adapt our institutional frameworks in pursuit of worthwhile reform. Also, much unilateral reform had been undertaken by States without any agreement on sharing the fiscal dividend, or provision for incentive payments. It was observed that although the Australian Constitution is, in practice, largely unamendable, there is unlimited potential for the Australian Government to centralise and the federal-state balance is determined politically, not constitutionally. This provides considerable scope for governments to collaborate and act cooperatively in the pursuit of better policy outcomes. Another participant observed that frequent and non-coincidental elections around the country were a larger 'barrier' to reform than the Constitution itself.

PART B

HEALTH REFORM

4 Health reform in the federal context

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4.1 Introduction

This paper canvasses the state of health care delivery and expenditure in Australia, and the roles in it of governments at each level in the federation. It draws primarily on a report prepared for the Victorian Government, entitled *Governments Working Together: A Better Future for all Australians* (Allen Consulting 2004a), which canvassed reforms to federal arrangements in the two major social policy areas — health and education. Other relevant contributions include the Productivity Commission's recent *Review of National Competition Policy Reforms*, especially Chapter 11 (PC 2005f).

This paper

Section 4.2 of the paper reviews evidence on the health status of Australians and data on health care spending. Section 4.3 draws out issues posed by present health care and funding arrangements — essentially, making the case that reform is required. Section 4.4 canvasses possible reforms, drawing on models that have been put forward in debate and overseas experience. Section 4.5 outlines a preferred reform approach and how it might be implemented.

This paper canvasses *systemic* reform, and does not canvass in any detail the possibilities for more immediate, *incremental* reforms. A range of such possible improvements (leaving the present system essentially intact) were canvassed in the Allen Consulting (2004a) report, encompassing, for example:

- better access to primary care and relief of pressures on emergency departments;
- improved (and better funded) access to elective surgery;
- improved and better coordinated aged care; and
- better service integration (such as for those with complex care needs).

The Productivity Commission (PC 2005f, p. 330) discussed various other incremental reforms, including in respect of the health workforce, private health insurance, patient information and choice. Like this paper, however, the Commission placed its prime focus on major reform to the system and concluded that a *national* and *integrated* approach, that is, one involving both the Australian Government and the States, is required. The Commission recommended that reform be initiated by an independent and comprehensive public review of the system in all its key aspects.

That is similar to the conclusion reached in the following sections of this paper, although we see a preferred overall reform direction is envisaged within which further study would focus on specific issues and approaches to implementation.

4.2 Context: health status and health spending

Health status of Australians

Australia spent $67 billion, or 9.3 per cent of GDP, on health care in 2001-02 — up from 8.1 per cent of GDP a decade earlier (see section below). A question which follows from the consideration of Australia's increasing expenditure on health care is whether the health system is delivering value for the money invested. Compared with other countries, it can be said that:

> Australians enjoy good health, that Australia is one of the healthiest countries in the world, and that the health of its people, by and large, continues to improve. (AIHW 1998, p. 2)

There is nevertheless considerable scope for further improvement. For example, there is increasing awareness of the numerous biological, behavioural and socioeconomic factors that increase the risk of ill health and which can be prevented or modified. Experience overseas suggests that much lower levels of some diseases are possible in Australia, such as death from heart attack. Finally, the poor health of certain groups in Australia indicates that much more needs to be done for those, particularly indigenous people and the disadvantaged.

About 70 per cent of the total burden of disease in Australia and almost 78 per cent of all deaths can be attributed to six disease groups (box 4.1). These account for an estimated 40 per cent of total health expenditure. Australian Health Ministers have identified these groups for special action under the National Health Priority Areas initiative (AIHW 2002a, pp. 103–4).

Box 4.1 **National health priority areas**

Six disease groups have been identified by the Australian Health Ministers for priority action:

- cardiovascular problems;
- cancers;
- injuries;
- mental problems;
- diabetes mellitus; and
- asthma.

Source: AIHW (2002a, p. 103).

Preventable disease

For each of the six groups, a certain amount of disease can be prevented, or its impact reduced, through improved health promotion and prevention (AIHW 2002a, ch. 2).

- Cardiovascular disease is the leading cause of *death* among Australians (39 per cent of all deaths). Its health and economic burden exceeds that of any other disease, and much of it is preventable (by diet, exercise and so on).
- About 30 per cent of *cancers* can be attributed to smoking and 30 per cent to dietary influences. Risks of particular cancers can be reduced (not eliminated) through better monitoring and early treatment.
- *Injury* contributes significantly to mortality and morbidity and is the leading cause of death of *young people* (suicide, followed by road accidents). Falls, mainly by older people, rank third.
- Mental problems and disorders are the leading cause of *disability* in Australia, 30 per cent of the non-fatal disease burden. Prevention and early-intervention programs allow management of risk factors. Disease-management programs can reduce severity.
- Diabetes is a *chronic* condition that contributes to disability and premature mortality. Incidence of type 2 diabetes increases with obesity and lack of exercise.
- Australia has one of the highest levels of *asthma* in the world. Asthma can be controlled by effective education, appropriate medication, identification of trigger factors and monitoring.

A high proportion of public hospital and other resources is used to provide services to people with preventable conditions (AHCARG 2002, p. 87). For example, about 90 per cent of type 2 diabetes, more than 50 per cent of cardiovascular disease and at least 50 per cent of cancers are preventable. Hence, there is an important link between prevention activities and the demands on hospitals and health services, and their cost.

Aboriginal and Torres Strait Islanders and the disadvantaged

Australians generally are very healthy, but the health status of Aboriginal and Torres Straight Islander people is significantly lower than the health status of other Australians and the association between socioeconomic disadvantage and health has been summarised as 'wealthy people are healthy people; poor people have poor health' (PC 2005f, p. 327; Sainsbury and Harris 2001, p. 117).

The mechanisms by which socioeconomic status influences health status include diet, behaviour (including smoking and lack of exercise), education, access to health services (both preventive and treatment), occupational exposures, quality of housing, and psychosocial factors (AIHW 2002a, p. 212).

Increasing expenditure on health care

Using constant figures, $3292 was spent on health care per person in Australia in 2001-02, compared with $2357 per person in 1991-92 — a real increase of 40 per cent in ten years (AIHW 2003b, p. 9).

Total spending on health care grew at a *real* average annual rate of 5.4 per cent between 1997-98 and 2001-02. It increased from 8.1 per cent of GDP in 1991-92, to 8.6 per cent in 1997-98 and to 9.3 per cent in 2001-02 (AIHW 2003b, p. 9). In comparison, the OECD average was 8.4 per cent of GDP in 2001 (OECD 2003, p. 121),[1] although for the subset of about ten OECD countries most comparable with Australia, the average is a little above Australia's level.[2]

Over the 1990s, real growth in recurrent health expenditure was concentrated in three areas:

- hospitals, which accounted for 25.7 per cent of the growth (public hospitals for 20 per cent and private hospitals for 5.7 per cent);

[1] The OECD average is based on 28 countries.

[2] PC (2005f, table 11.2, p. 326) showing, on slightly later data than the above (for 2002), Australia at 9.5 per cent of GDP and the OECD ten averaging 9.7 per cent of GDP. More than half the countries included in the OECD ten spend between 9 and 10 per cent of GDP on health.

- pharmaceuticals, which accounted for 24.3 per cent; and
- medical services, which accounted for 15.8 per cent.

Expenditure on residential aged care accounted for only 4.3 per cent of the growth.

The main drivers of the steadily increasing expenditure have been:

- rising consumer expectations;
- technological advances that offer improved outcomes at higher cost and help drive expectations;
- cost factors such as labour costs, medical equipment and supplies, and insurance issues; and
- increasingly in future years, ageing in combination with all the above.

After accounting for population growth and ageing, increased *demand* for (and supply of) services driven by technological change and the rising consumer expectations it stimulates comprises almost two-thirds of projected future expenditure growth (HMRSR 1999, pp. 83–4; Richardson and Robertson 1999).

As has been observed:

> The forces that have driven up health costs over the long haul are, if anything, intensifying. The staggering fecundity of biomedical research is increasing, not diminishing. Rapid scientific advance always raises expenditure, even as it lowers prices. (Aaron 2002, p. 1)

Medical technology is, however, not only a driver of health care costs, but also of health care improvement. Over the 20th century, according to a paper by McGinnis, Williams-Russo and Knickman (2002), only about 5 of the 30 years of increased life expectancy could be attributed to better medical care. But the contribution of medical care to life expectancy rose in the latter part of the century and is likely to continue to do so as technology improves health care. According to a paper by Rice:

> … the overriding pressures on future costs will be due to the demand-side of the health care market. Undoubtedly, supply factors also play a role… But the major drivers of increased future costs are very likely to be the ability of medical care to improve health, coupled with rising consumer expectations that these treatments should be made available. (Rice 2002, pp. 68–69)

There is also evidence that the effectiveness of medical intervention is improving (Cutler and McClellan 2001; Lichtenberg 2001; Or 2000). This represents a major change from the past, when the evidence suggested that, among people with access to good health care, there was only a marginal gain from additional health service usage; non-medical factors were far more important. This suggests that the developed world might be entering a period of renewed health care cost pressures,

sustained largely by a leap in the ability of medical care to provide better and longer life. It is thus not surprising that spending on health care in Australia is credibly projected to rise to about 17 per cent of GDP by 2041 (Owens 2002, p. 6). *Publicly funded* health care costs account for most of the projected increase, as noted by the PC (2005f, figure 11.1, p. 327).

It is not possible to say whether current or projected expenditure on health care is just right, too little, or too much. The answer depends upon our preferences, the opportunity costs of the expenditure (what else we could buy with the money), and the cost effectiveness of expenditure — that is, whether we are getting value for it (Rice 2002).

Certainly the projected increases in health spending which will put pressure on the funding of other services, places a particular responsibility on both levels of government, the major funders of health care, to ensure that health expenditure is equitable and cost effective. Current governmental arrangements are clearly not optimal in that regard.

4.3 Diagnosis: issues with the present system

Current funding arrangements

The flow of money around the Australian health care system is very complex under the institutional frameworks in place.

- Universal cover for privately provided medical services is largely funded by the Australian Government under Medicare, with copayments by users where services are patient-billed.
- Eligibility for public hospital services, free at the point of service, is funded approximately equally by the States and the Australian Government.
- Growing private hospital activity is largely funded by private health insurance, in turn subsidised by the Australian Government through the 30 per cent rebate on fund members' contributions.
- The Australian Government, through its Pharmaceutical Benefits Scheme (PBS), subsidises a wide range of medicines outside public hospitals.
- The Australian Government provides most of the funding for high-level residential aged care, for health research and services for veterans.

- State Governments are primarily responsible for mental health programs, the transport of patients, and community and public health services such as health promotion and disease prevention.
- Individuals primarily spend money on pharmaceuticals, medical and other professional services (AIHW 2003b, pp. 1–3).

The bulk of health care expenditure (68 per cent) is funded by governments — 46 per cent by the Australian Government and 22 per cent by State and Local Governments. For both levels of government, health funding comprises a significant component of their budgets, and their respective areas of responsibility are under financial pressure — for the Australian Government in pharmaceuticals, and the States in public hospitals. As many authoritative observers, including the Productivity Commission (PC 2005f, pp. 326–27) and the OECD (1999, p. 144), have pointed out, health spending poses the major risk to government finances overall in the long term.

Issues arising

Cost shifting

One inefficient result of a fragmented funding system under budgetary pressure is cost shifting between governments. With the Australian Government responsible for subsidising private medical services and the States funding public hospital services, there is an incentive for each level of government to design their program arrangements so that services will be delivered so that the other level of government meets the cost, even though this may result in the patient not being treated optimally. For example:

- public hospitals (State funded) may refer patients being discharged to their GP (Australian Government subsidised) instead of providing post-hospital services directly;
- on the other hand, if patients have difficulty in accessing GP services (for example, after hours), they may attend public hospital emergency departments to receive primary care services (State funded); and
- shortages of Australian Government-subsidised residential aged care places are resulting in public hospital beds being inappropriately occupied on a long-term basis by elderly patients.

These examples demonstrate that the manner in which one government funds (or fails to fund) health services can have significant flow-on implications for the health services funded by another government and result in less than optimum health care

for patients. Rather than which government bears the cost, the central issue should be which setting will provide the most effective (and cost-effective) care for the patient. Current arrangements do not ensure this.

Funding and continuity of care

Current funding and delivery arrangements also create barriers to continuity of care. Because of the complexity of the health system, it is difficult for people to identify the services they require, arrange to receive them and navigate their way through the health system without expert help.

Care is fragmented, treatment tends to be episodic, and information systems do not facilitate communication between providers. Patients are also likely to encounter differing rationing arrangements, with some services free of charge, while others require a patient copayment. Patients may also have to wait to receive services that ideally should be immediately accessible.

Further, while there have been significant changes in clinical practice and health care delivery since Medicare was introduced in 1984, funding arrangements remain largely unchanged and reflect historical practice rather than contemporary models of care and clinical practice (AHCARG 2002, p. 33). When Medicare was introduced in 1984, patients admitted to hospitals usually had multi-day stays and there was a strong focus on institutional care. Now, many types of care, including dialysis and chemotherapy, are routinely provided on a same-day basis and often in community settings or at home. Models of care are now quite different. Illustrations of these changes are given in box 4.2.

There are significant differences between programs in *how* services are funded, which have implications for cost pressures. For example, while funding for public hospitals is capped, funding under the Medicare Benefits Schedule (MBS) and PBS and for the private health insurance rebate is uncapped. Further, except in the public hospital system (and to a lesser extent in private hospitals under contract arrangements with health funds), there is an absence of countervailing budget-holder entities.

Under uncapped fee-for-service arrangements, there is the possibility of supplier-induced demand and of less appropriate treatments. For instance, a recent review has raised the possibility of increased 'over-utilisation' of private hospital care due to the impact of private health insurance policies in Australia, which have decreased the ability to contain utilisation (Dawkins et al. 2004, pp. 41–2).

Box 4.2 **Changes in clinical practice and the delivery of health services**

Average length of stay in public hospitals has dropped from 6.9 days in 1985-86 to 3.8 days in 2001-02.

In 1984, day surgery centres were virtually non-existent. In 2001-02 there were 246 operating nationally.

Now over 80 per cent of lens procedures are done on a day-only basis, and over 99 per cent of all dialysis and chemotherapy is done on a day-only or outpatient/ambulatory basis.

Endoscopy was performed largely on an admitted-patient basis in 1984. Today, essentially all endoscopy is performed on an ambulatory basis either at a hospital or in doctors' rooms.

Factors such as the above have led to the numbers of public hospital beds per 1000 people declining by 28 per cent since 1984, to 2.7 per 1000 people.

'Hospital in the home' did not exist in 1984. It is now a viable alternative to in-hospital stay, and health funds can offer coverage for it.

Source: AHCARG (2002, pp. 32–3); AIHW (2003a, tables 2.1 and 2.3).

Hospitals

Access arrangements are very different for public hospitals and private hospitals.

Public hospitals

In 2001-02, there were 746 public hospitals with 51 461 available beds, providing 3 968 000 patient admissions and 5 754 666 accident and emergency occasions of service across Australia (AIHW 2003a, pp. 14, 16 and 21).[3] Under the Australian Health Care Agreements (AHCAs) between the Australian and State Governments, public hospital services must be provided free of charge on the basis of clinical need.

Demand for public hospital services has steadily increased over the past few years. Between 1997-98 and 2001-02:

- separations in public hospitals increased by 5.3 per cent — or nearly 200 000 additional separations a year; and

[3] Figures are for public acute and public psychiatric hospitals.

- occasions of service at emergency departments increased by about 12 per cent — or more than 600 000 additional services a year (AIHW 1999a, table 4.5; AIHW 2003a, tables 2.3 and 2.5).

With the increase in use of emergency departments, concerns have been raised about the capacity of the system to respond. Data on the adequacy of access to emergency department services related to the urgency of treatment required (the triage category) (SCRGSP 2003, pp. 9.42–9.44) show that very nearly all patients (99 per cent) who are in triage category 1 (resuscitation) are seen immediately, but much lower proportions of patients in other triage categories are seen within the time limits set for treatment, with considerable variation among the jurisdictions in waiting times.

Difficulties with access to emergency departments are an example of the potential flow-on implications of one government's health policies for another government's health services. One estimate is that one in five people who attend emergency departments would more appropriately be treated by a GP (SSCM 2003, p. 51). A recent analysis in NSW showed that in towns where GPs do not bulk bill, people use public hospital emergency departments around 60 per cent more than in those towns where GPs do bulk bill (AHCARG 2002).

There are also concerns about the adequacy of access to elective surgery in public hospitals. Data on time waited for admission for elective surgery show increased numbers of waiting days at which 90 per cent of patients were admitted, based on the time between when a patient was first included on a waiting list and when the patient was admitted (SCRGSP 2003, pp. 9.43–9.46) [4]:

- in 2001-02, 50 per cent of (public) patients on a waiting list for elective surgery waited 27 days for admission on average across Australia;
- 90 per cent of patients were admitted within 203 days; and
- there has been an increase in long-waits, with 4.5 per cent of patients waiting more than a year for admissions in 2001-02 compared with 3.1 per cent in 1999-2000.

Across the jurisdictions there is considerable variation in waiting times. For example, 9 per cent of patients waited more than one year in Tasmania compared with 3.6 per cent in Queensland. There are also significant variations in waiting times for elective surgery depending on the speciality of the surgeon and the procedure.

4 This indicator does not take into account clinical urgency, due to the systematic differences across jurisdictions in the judgements applied by clinicians about the urgency of cases, which significantly affects the comparability of the data.

The financial costs *to the health system as a whole* of waiting for surgery may actually be higher than the costs of surgery. For example, a person waiting for a hip replacement may incur significant costs for medication and services to manage the condition (AHCARG 2002, pp. 46–7).

Private hospitals

Over the last twenty years, there has been growth in the capacity of the private sector, both in offering dedicated day-procedure facilities and in offering a more complex range of services. With the exception of some super-speciality services (such as transplantation), some large metropolitan private hospitals now offer comparable services to the major public teaching hospitals. Intensive care, cardiac surgery, neurosurgery, renal dialysis and oncology are among the services that have become increasingly available in private hospitals (ABS 2003, p. 25; AHCARG 2002, p. 33).

Nevertheless overall, the private hospital sector still concentrates on elective surgery (with little or no focus on medical patients and accident and emergency services), and the average complexity of cases treated in private hospitals is still less than in public hospitals (Duckett 2004, p. 5 and pp. 12–13).

In recent years, the Australian Government has introduced a package of measures to encourage the take-up of private health insurance (PHI):

- the 30 per cent rebate on PHI premiums;
- an additional 1 per cent tax surcharge for high-income individuals who do not have PHI; and
- Lifetime Health Cover, which places a surcharge on premiums for people who wait to take out private health insurance until they are older (DHA 2003, p. 6).

The measures (in particular, Lifetime Health Cover) resulted in an increase in the proportion of people with PHI coverage, from a low of 30.2 per cent of the population in 1998 to a peak of 45.7 per cent in 2000. (As of September 2003, 43.3 per cent of the Australian population was covered by PHI.) There has been a consequential significant increase in access to private hospitals:

- separations at private hospitals increased on average by 7.9 per cent a year between 1997-98 and 2001-02, compared with a 1.3 per cent increase in separations in public hospitals; and
- in 2001-02, private hospitals accounted for 38.0 per cent of patient separations compared with 32.4 per cent in 1997-98 (AIHW 2003a, p. 16).

Private hospitals are becoming the major alternative pathway for people who need elective surgery, with more than 50 per cent of all elective separations undertaken in private hospitals (54 per cent in 2001-02). This raises an important issue of equity of access to elective surgery for people who do not have PHI, or who do not have access to a private hospital (Dawkins et al. 2004).

Other questions have been raised about the cost efficiency of the PHI rebate:

- first, it has been estimated that in many cases the rebate subsidises households who would have purchased PHI in any case (Dawkins et al. 2004);
- second, the evidence suggests that most of the increase in membership of health funds was because of the introduction of Lifetime Health Cover rather than the rebate (Butler 2002); and
- third, the available evidence, while limited, suggests that the Australian Government's PHI policies have been largely ineffective and inefficient as a means of taking pressure off the public hospital system, with only a small reduction in demand for public hospital services (Segal 2004). One factor is that insured people often choose a public patient admission to avoid out-of-pocket costs. Victorian and South Australian survey data show that about 60 per cent of people with PHI admitted to public hospitals choose to be admitted as public patients.[5]

Aged care

Good access to aged care is increasingly important for many families, due to the ageing of the population. The Australian Government has set targets for aged care services per 1000 people in the population aged 70 years and over: 40 high care places, 50 low care places, and 10 community aged care packages (CACPs). In 2003, these targets were met at the national level for high care places and CACPs, but there were only 42 low care places per 1000. Also, the target for high care places was not met in all States (SCRGSP 2004, table 12A.10).

There are two indicators available for timeliness of access to aged care services. The first is the elapsed time between assessment by an Aged Care Assessment Team (ACAT) and entry into a residential care service (SCRGSP 2004, p. 12.25). In summary, in 2002-03:

- On average, 73 per cent of people entered residential care within three months of being assessed by an ACAT (ranging from 50 per cent in the ACT to 77 per cent in NSW).

[5] Victorian Department of Human Services, unpublished paper.

- Nationally, 81.5 per cent of people entered *high care* residential services within three months of assessment compared with 61.5 per cent entering *low care* residential services within that time. These figures also varied considerably across jurisdictions.

The second indicator of access is the elapsed time between an ACAT assessment and the receipt of a community care service. This partly reflects the extent to which aged care services meet the demand for community care services. This indicator is reported using CACP data (SCRGSP 2003, table 12A.37):

- on average, 67 per cent of all people receiving a CACP during 2002-03 had received it within three months of being assessed by an ACAT, the figure varying between 43 and 77 per cent across jurisdictions.

These shortages and delays impact on the effective and efficient running of the health system as a whole by increasing older people's need for other services (for example, occupying hospital beds).

Interface between aged and acute care

The interface between the public hospital sector and the aged care sector is complex.

Acute care is more focused on efficient management of specific medical and surgical crises. Interventions are highly targeted in method and approach, and lengths of stays are kept to a minimum. This can be at odds with older people's needs, including their requirement for a multidisciplinary approach to deal with their multiple issues, their more intense rehabilitation needs and slower recovery time (Duckett 2002).

Growing numbers of older people are remaining in hospitals for extended periods after an acute episode (an average of 20 days delay in moving to residential aged care), exacerbating capacity pressures being felt by the acute sector:

- in 1999-2000, the total opportunity cost was over 50 000 average public hospital admissions (Duckett 2002, p. 130).

The aged care sector has undergone significant change with the introduction of accreditation for residential care facilities, 'ageing in place' and greatly increased demand for more intensive community-based forms of care and support, including Home and Community Care (HACC). As a consequence, residents of aged care facilities tend to be older, frailer and sicker and have higher levels of dependency. There are indications of a growing need for alternative care options, including sub-acute and transitional care for older people with complex needs.

These issues are complicated by the boundaries in funding responsibilities between the Australian Government and the States, and between public and private health sectors. Collaborative work at the interface between hospitals and long-term aged care has the potential to deliver more appropriate care options and better health outcomes for older Australians as well as improved demand management.

Appropriateness of care generally

There is a range of evidence that Australia has an over-reliance on acute care when alternative care options would not only be more appropriate but also cost effective. For example, hospital-in-the-home programs are increasingly feasible and sub-acute and transition care often offer more cost effective and appropriate care for patients with complex needs.

Services should be *seamless* from the patient's perspective, emphasising *continuity of care* (AHCARG 2002):

- In particular, care provided within hospitals should be seen as part of a continuum, encompassing prevention, diagnosis, ongoing treatment, acute care and rehabilitation.
- Non-admitted services are also part of a continuum of care, and presentation to emergency often leads to an episode of inpatient care or to identification of ongoing health service needs. People may continue to receive services from their referring practitioner before and after being outpatients.
- In particular, the care of people with chronic and complex problems requires a fundamental rethink of the delivery of health services. Hospitals play a vital role, but general practice and community health services have a significant role in the management of patients with chronic disease (for example, diabetes).

A further issue, as the Productivity Commission has observed (PC 2005f, p. 328), is that many areas of health care are not subject to an evidence-based approach to assessing the appropriateness of medical procedures and practices.

Workforce issues

A recurrent issue in the Australian health system is the emergence, to varying degrees at different times and in different parts of the system, of shortages of personnel such as nurses, general practitioners, some types of medical specialists, dentists and so on. These issues, as the Productivity Commission observes, are exacerbated by demarcation issues (who can do what for whom) (PC 2005f, p. 328). Health workforce issues have been recognised by CoAG, which has commissioned

a study of the issues by the Productivity Commission.[6] As the first part of its formal response, the Commission (PC 2005b) released a position paper entitled *Australia's Health Workforce* on 29 September 2005.

Conclusions

There are clearly many areas of health care where more resources are needed, particularly for primary and preventive care, aged care and elective surgery. The poor health of particular groups in Australia also indicates that more needs to be done, especially to improve the health status of indigenous and socioeconomically disadvantaged people.

These issues raise questions about the adequacy of funding for health care, but given the significant real increases in health funding over the past decade and projected into the future, it is just as important to consider the cost effectiveness of funding.

The two major levels of government share the responsibility to ensure health expenditure is adequate, equitable and cost effective. The complex split in responsibilities for funding and provision of health care leads to poor coordination of planning and service delivery, barriers to efficient substitution of alternative types and sources of care, and scope for cost shifting. The funding arrangements do not encourage continuity of care, provision of multidisciplinary care, or provision of care in the most clinically appropriate setting. There is a lack of focus on prevention, health promotion and disease management.

4.4 Possible Reforms

Principles guiding the allocation of governmental roles

As for the question of how the two levels of government should ideally divide roles in health between themselves, some well known principles of good public administration readily apply, particularly these:[7]

- the principle of *subsidiarity*, which is the concept that a function should be carried out by the lowest level of government able to exercise it effectively —

[6] CoAG commissioned the study on the health workforce at its meeting on 25 June 2004.

[7] The exposition of the relevant principles here broadly follows the discussion of them by the National Commission of Audit (NCA 1996, ch. 4).

and thus as close as possible to the ultimate clients, to allow them choice in how they receive services:

  - while in some cases *national considerations* may point to the higher level of government carrying a function (for example, progressive income taxation), even though it is within the administrative capacity of the lower level;

- ideally, the totality of the responsibilities of each level of government should be broadly *aligned* with its effective command over revenues; and
- where *both* levels of government need to be involved jointly in the same area (as in health):
  - *both levels of government* need to work collaboratively to resolve national aspects of issues, in the interests of Australia as a whole — the so-called 'Australian nation' principle (Mathews and Grewal 1997, p. 558);
  - the States have primary roles in identifying the needs of their communities and in developing policy and program responses to them;
  - the Australian Government has primary responsibility for the minimum standard of services that every Australian should have access to; and
  - appropriate *co-funding and risk sharing* arrangements should apply.

Advantages of federal systems

A federation intrinsically has great advantages over a unitary state in that it allows, and can indeed be structured to actively promote diversity and innovation across and within its sub-national jurisdictions (states, provinces or territories) in what and how services are delivered in response to local needs and preferences.

An example in the health context of an innovation in one State spurring innovation throughout the federation is the introduction in Australia of casemix funding for public hospital inpatient services. Casemix was pioneered in Victoria, which introduced it in 1993-94 as a means to improve efficiency in the health care system and better control health expenditure. The system was then taken up in 1994-95 by South Australia and over the following few years by States other than New South Wales, each adapting it to its own circumstances and varying among them in the effectiveness with which it was used to drive efficiencies. (The Territories' populations are too small for full-scale use of the system, but they use elements of it.) New South Wales does, however, use part of the framework (Diagnosis Related Groups, or DRGs) for tracking and research purposes.[8]

[8] For a description of how casemix developed in Australia following Victoria's lead, see Duckett (1998). For a recent update, see Drouin and Hay (2005).

It is instructive to note the trend in some unitary states to devolve large areas of policy and administration, particularly in core social areas such as health and education, back to the sub-national level. Nowhere has this movement been more dramatic than in the United Kingdom, where in the past decade a Scottish Parliament and a National Assembly for Wales have been established, along with corresponding executive governments. The Scottish Government, on its website (http://www.scotland.gov.uk) lists the following as its top two functions:

- health; and
- education and training.

The Welsh Assembly Government lists on its website (http://www.wales.gov.uk) essentially the same two top priorities.

In the Australian context, the State level of government is inherently the more responsive to differences in the circumstances and preferences of (say) North Queensland versus Tasmanian communities. On the other hand, the Australian Government may be best placed to ensure that both are treated equitably in the distribution of income and have access to core services to at least a minimum national standard, in *outcome* terms.

Diversity as a key driver of improvement

Thus it is very important that the concept of a *nationally consistent* approach is not confused with a one-size-fits-all *uniform* approach. On the contrary, it is essential that reform positively promotes diversity in the area of the particular services provided and how they are customised and delivered.

- Diversity is in fact a key catalyst for innovation, without which service improvement cannot occur.
- In a collaborative federal model, the benefits of diversity and innovation can be picked up and adapted, or used to prompt new ideas, across the nation.

Reform directions: an integrated health care system

Many previous studies of the problems of Australia's health system have argued that an essential reform is the *integration* of federal and state health care programs through funds-pooling and budget-holding. Various models have been proposed, including:

- A *Joint Federal–State Health Commission* (proposed by John Menadue) in each State which would receive a negotiated allocation of funds from the Australian Government and relevant State Government covering acute, primary and

community health care services. It would manage the funding and planning of all relevant health services in that State, purchase various services from providers, and monitor performance against agreed targets (Menadue 2004).

- *Managed competition* (proposed by Richard Scotton) which would also involve the pooling of federal and state funds. However, in addition, it would involve more significant structural reform of the health system, as it would integrate private sector funding and service provision into a national program (PC 2002).

Approaches with some similarities are being explored or actively implemented in a number of countries comparable to Australia, including England and New Zealand. There is now emerging evidence that closer integration of clinical decision making and purchasing for enrolled populations through funds-pooling and local purchasing has the potential to increase innovation, reduce costs and improve health (AIPC 2004).

The key features of these emerging approaches are (Segal et al. 2002):

- universal coverage, with financing for health care provided from taxpayer funds, at least in the main;
- a regional population model, with a regional health authority, the fundholder, responsible for the health of all residents within a defined geographical region;
- the regional health authority having control over a budget, based on a risk-adjusted capitation payment, and a mandate to purchase (arrange and fund the provision of) all relevant health services for the defined population; and
- the health authority negotiating performance-based contracts with providers for health care services.

The incentives for the fundholder in this model derive from long-term control over the entire health budget for the designated population, given an expectation of low membership turnover tied to residential relocation. The fundholder thus has *continuing* responsibility for the health needs of the enrolled community. This model provides capacity and incentives for continuity of care, service integration, and coordination and innovation.

The long-term focus dictated by low turnover of membership puts the emphasis on improving the health status of individuals and populations through enhanced quality of care. There are also strong incentives for public health and population health initiatives (Segal et al. 2002). The model thus maximises the possibilities for substitution between more and less cost-effective interventions, even where benefits accrue downstream in the future (Segal et al. 2002).

Details of the approach adopted in New Zealand and England are set out in boxes 4.3 and 4.4. In both cases, district authorities with budgetary, performance and organisational responsibility for the health of a catchment population negotiate contracts with primary care practices for primary care. The focus of primary health reform shifts from traditional, individually focused general practice to a more integrated population-focused approach.

Box 4.3 **Primary organisations in New Zealand**

In New Zealand, District Health Boards have responsibility for health planning, purchasing and performance management for a regional catchment area. They hold budgets and negotiate agreements with providers.

Primary Health Organisations (PHOs) are local groups of providers whose job it is to look after all the people enrolled with them. The group always includes a GP and may also include nurses, pharmacists, dieticians, mental health workers, community health workers and dentists. While primary health care practitioners are encouraged to join PHOs, membership is voluntary.

The essential features of PHOs are:

- Their aim is to improve and maintain the health of their populations. They are required to provide at least a minimum set of essential population-based and personal first-line services, including population services to improve health, screening and preventive services, support for people with chronic health problems, and information, assessment and treatment for episodes of ill health.
- PHOs are required to work with other providers within their regions to ensure that services are coordinated around the needs of their enrolled populations.
- Payments to PHOs are based on a blended combination of capitation, management and other payments.
- PHOs may charge copayments for specified services but they are required to adhere to fee-setting principles and specify their fees as part of the agreement.
- Enrolment is voluntary and people are allowed to change their nominated provider. Between 2001 and mid-2003, 47 PHOs were established, covering approximately 1.7 million New Zealanders (or nearly 50 per cent).

Source: AIPC (2004).

Box 4.4 **Primary care trusts in England**

In England, there are approximately 300 Primary Care Trusts (PCTs), with responsibility for managing all health care for catchment populations. They have three main functions:

- improving the health of the community through community development, service planning, health promotion, health education, commissioning, occupational health and performance management;
- providing or securing primary care, community health, mental health and acute secondary care services; medical, dental, pharmaceutical and optical services; emergency ambulance and patient transport services; and population screening programs; and
- integrating health and social care locally.

Their main features are:

- PCT boundaries are aligned with local government and usually have populations between 100 000 and 200 000 people.
- PCTs have responsibility for community health and general practice services. They employ some staff and negotiate general medical service contracts with independent general practices and agreements with National Health Service (NHS) Trusts (acute health providers) to provide services for their population.
- They are funded by the Department of Health based on their catchment population characteristics. In 2002, PCTs controlled around 50 per cent of the NHS budget, rising to 75 per cent in 2004.

Performance-based payments based on the implementation of a quality framework and the achievement of patient outcomes comprise a significant component of general medical service practice income.

In the UK, services are effectively free to the majority of patients.

Source: AIPC (2004).

4.5 Implementing an integrated health care system

Overall considerations

While in theory an integrated health care system would seem an obvious way to go to address Australia's problems of fragmentation of health care funding and delivery, in practice implementing an integrated health care system would be very complex, difficult and time consuming. It would require a great deal of collaboration among the Australian and State Governments in respect of

governance, system, organisational and workforce development. Considerable institutional effort would also be required to support change. In the United Kingdom for example, a Modernization Agency has been established for the NHS.

There are a number of elements that would be important in implementing an integrated health care system in Australia. The key elements are listed in box 4.5 and discussed subsequently. It is obvious from the scope of the elements that a new integrated care model could not be introduced overnight, as it would require significant changes to current federal–state funding and health care responsibilities. In addition, more careful analysis and broader discussion are required in terms of the specific model for integrated care most appropriate for Australia.

Box 4.5 **Key elements of an integrated health care system**

- Purchasing arrangements:
  - funds-pooling
  - allocation of funds
  - purchasing agency
- Providers
- Service agreements
- Governance arrangements

We do not put forward a specific model for implementation, to avoid unnecessary debate about the details of the model, rather than about the key directions for reform. If the Australian Government and States agree to pursue the advantages of an integrated health care system, it is suggested that it should be the responsibility of an envisaged joint implementation body, the 'Australian Health Commission' (AHC), to develop a detailed model.

Purchasing arrangements overall

Integrated care aims to facilitate the coordination of patient care, particularly through reforms to arrangements for the purchasing of health care consistent with a strategic purchasing approach, ensuring that the 'required services in the right volume are delivered at the right quality and at the right price' (quoted in Phillips Fox and Casemix Consulting 1999, p. 42).

There are three important aspects to the new purchasing arrangements: the pooling of health care funds, the allocation of funds, and the agency distributing the funds.

Funds-pooling

An essential component of integrated care is the pooling of funds for health services. Ideally, this would mean *pooling of funds* across programs (MBS, PBS, acute care, other public and community health care, and aged care), as well as across jurisdictions. Boundaries between health programs are removed, providing opportunities for substitution of health services, with the aim of improving the coordination and appropriateness of care. Efficiency is improved through reduced program complexities and cost shifting.

Purchasers

Purchasers are then allocated funds from the pool to manage the health care needs of specified population groups by buying health services from providers. Thus they must carefully consider how patients should be treated and how ultimately they can be kept 'healthy', since they are responsible for deciding upon care within prescribed fund-pooling budgets. Health care becomes more patient-oriented and responsive to individual health care needs.

Better integrated, more cost effective care is encouraged through two central characteristics of pooled funding: responsibility for financial risk, and responsibility for the health of a population. Through financial risk sharing, purchasers have an incentive to manage the health of the people in their population to minimise expensive treatment costs or eliminate them all together through preventive medicine. Responsibility for the health of a population ensures that purchasers are better able to provide continuity of care. It also enhances their bargaining capacity.

In designing an integrated health care system, the broader the scope of services included, the greater the opportunities for substitution of health services, continuity of care, and cost control. If the scope is restricted, this creates opportunities for cost shifting.

Allocation of funds

In a federal–state integrated health care system there would be two levels of funds allocation. First, funds would be allocated to each State. For example, a practical approach would be to base funding on the current allocations of federal and state funds for health services for a particular State. Alternatively, there might be a common formula, but with an offsetting adjustment to other payments to ensure budget neutrality.

Second, funds would be allocated from the State Government to the regional purchasing agencies within the State, based on risk-adjusted capitation payments. That is, funds would be allocated to reflect the level of patient need through adjustments for factors such as age, sex, socioeconomic status and location (Scotton 1998, p. 227).

Purchasing agencies

Under a pooled-funding model, the purchaser can thus make informed decisions as to the mix of services to be purchased and can utilise and reward different providers in relation to their efficiency and quality (Phillips Fox and Casemix Consulting 1999, p. 82). It can thus be a force for encouraging all providers to move towards best practice.

Purchasing agencies are thus organisations that, at their best, bring together expertise in clinical practice, public health, general management, planning, finance, performance monitoring and community participation, and achieve strategic change through the use of their financial and other resources (Ham 1997, p. 58).

Under an integrated health care model, each State, together with the Australian Government, would need to identify appropriate catchment areas and create the purchasing agencies to take responsibility for them.

In identifying appropriate catchment areas, an important point is that risk, in terms of variations in expenditure, is more easily managed with larger populations, also allowing purchasers to take advantage of economies of scale and gain better bargaining capacity with providers (WHO 2000, p. 105). It has been estimated that with a scheme membership of 100 000 people there is only a 0.1 per cent risk that actual expenditure will be more than 10 per cent greater than predicted (Segal et al. 2002, p. 58). The risk would decline further for larger populations.

For an integrated care model based on budget-holding for both acute and primary care, Jeff Richardson has suggested that a total of between 18 and 30 regional budget-holders would be appropriate for Australia (Richardson 2003). Purchasing agencies (or 'Regional Health Agencies' (RHAs)) could be based on existing entities such as the health care networks of the various State Health Departments or Divisions of General Practice.[9]

[9] Some countries have introduced competing purchasers on the grounds of offering greater consumer choice and responsiveness. However, a major World Health Organization review urged caution in adopting competition between purchasers, arguing instead that effort should concentrate on reforms to the delivery of health care as these had demonstrated greater success (Ham 1997, pp. 14–15).

Providers

Under an integrated health care model, providers of health care services can be private or public organisations that provide a variety of primary, secondary and tertiary health care and community health and aged care programs.

At the provider level, greater integration of care aims to encourage the facilitation of more seamless service provision for patients to allow health care programs to be more effectively linked. This tends to shift thinking away from 'stand alone' health care provision through hospitals, medical services and the like, to a 'network' of health care providers.

With a broad scope of services included within the pooled funding arrangements, the role for coordination of patient care will increase. In Australia, as GPs are traditionally the first point of contact within the health care system, their role as 'gatekeepers' would be strengthened, particularly for patients with complex health needs or chronic diseases. GPs would have a greater case management role in terms of ensuring that health care services are organised for patients to ensure integrated health care delivered by the health care service or provider most appropriate for the patient's needs (for example, specialist, community health services, aged care services).

To facilitate continuity and integration of care, under an integrated health care system people are often either encouraged or required to enrol with a GP practice or primary care organisation, as in New Zealand. In this approach, it would be necessary for government to address any gaps in primary care services, for example, in rural areas.

Service agreements

The regional budget-holding agencies would be responsible for negotiating and contracting service agreements (contracts) with providers for the health care needs of the population. They would also develop accountability arrangements and monitor performance. Contracts could be entered into with private GP practices, public hospitals, community health organisations, local governments and so on. There could be financial incentives for groups of primary care practitioners (for example, GPs, nurses, dieticians and physiotherapists) to form primary care organisations, as in New Zealand. These organisations would either provide services themselves or make referral arrangements with a range of local practitioners.

Contractual care management for defined practice populations has a number of advantages for specifying quality, service levels, service coordination arrangements, consumer access and possibly equity and access provisions, such as requirements for no patient copayments. The payments could be a combination of capitation, fee-for-service and performance-based,[10] as in the UK.

The Australian Council for Safety and Quality in Health Care (ACSQHC 2003, pp. 3–4) supports the development of a new accountability for clinical governance underpinned by contractual arrangements to clarify and strengthen responsibilities for patient safety and quality of care. Contract funding of providers would provide greater opportunities than traditional fee-for-service to advance quality, safety and appropriateness of care by ensuring 'it is embedded in day-to-day management and that it is on a par with accountabilities in place for financial management' (ACSQHC 2003, p. 4).

What would be the role for private health insurance?

In the context of such significant reform of Australia's health care system, it is relevant to ask what the role would be for private health insurance.

As outlined earlier, there would be universal coverage for all Australians under an integrated health care system and regional budget-holding agencies would have responsibility for the health care needs of all residents in their geographical area. However, it is envisaged that it would still be possible to take out additional private health insurance with the aim of gaining quicker access to elective surgery, wider coverage of services that are not included under the universal system, and access to better amenities in hospitals. More fundamental options for private health insurance are a much bigger subject, not pursued here.

Governance

Clarifying the respective roles and responsibilities, accountability requirements, and reporting relationships of the main players in an integrated health care system would be an important part of designing a new system. There are four main players involved in the integrated health care system outlined above:

[10] Assuming that there is a degree of supplier-induced demand in areas of high GP supply, funding for contracts would effectively add only marginal costs to federal and state outlays. The GPs required to service contracts would most likely be diverted from areas of comparative workforce over supply, and/or existing practices in areas of workforce need could cash out their MBS arrangements through contracts. In either case, MBS fee reductions would offset funding allocated through contracts.

- Australian and State Governments;
- the Australian Health Commission;
- the Regional Health Agencies; and
- health care providers.

It is not appropriate at this early stage of outline of a possible new system to define fully the required governance structure and arrangements. The aim of the discussion below of the roles, responsibilities and accountabilities of the main players is to indicate the importance and range of issues to be considered.

Australian and State Governments

As an illustration, the Australian Government and States would have joint roles and responsibilities in determining:

- The broader health policy framework, including health priorities, within which an integrated care model would fit.
- The overall design of an integrated health care system, including goals and objectives, planning and priority-setting processes, and monitoring and reporting arrangements, such as quality assurance, health outcomes and financial targets.
- The regional purchasing agencies and their roles and responsibilities. The agencies could be based on existing entities such as the health care networks of the various State Health Departments or Divisions of General Practice.
- Core service specifications.
- Budgets and the resource allocation formula.

The Australian Government would also focus on:

- policy leadership in respect of national considerations and national health policy issues; and
- those roles for which significant economies of scale accrue from concerted national action (such as price negotiations on pharmaceuticals).

The States would also be responsible for:

- providing policy leadership relating to cost-effective, flexible and responsive service provision tailored to the needs of their communities; and
- providing public hospital care.

Accountability requirements flow from the roles and responsibilities. Given their joint responsibilities for funding, designing and directing the new integrated health

system, the Federal and State Ministers would have overall accountability for the effective and efficient operation of the system in each State. State Ministers would retain accountability for public hospitals (as key providers).

Australian Health Commission

As suggested earlier, a joint federal–state national body — such as the proposed Australian Health Commission (AHC) — would in our view be necessary to drive the reform process. The AHC would report to and advise the Federal and State Health Ministers. Given its role as a policy formulation, advisory and monitoring body, the AHC would only need to be a small agency and could be staffed from officers from both the Australian Government and the States.

One of its first tasks would be the development of a framework for an integrated health care system, including national policy, goals and objectives, and planning and priority-setting processes to ensure greater alignment of federal and state priorities. The AHC would also have responsibility for leading the necessary capacity-building and would advise on national strategic plans, high-level budget allocations and associated performance measures, as well as operating a national reporting framework.

It is essential that *all* the States and the Australian Government be involved in the design of the *framework* for an integrated health care system. Being involved in the development of the framework is important for three reasons:

- Both levels of government have unique perspectives to bring to bear that will impact on the successful implementation of the model. For example, the States have better understanding of service provision ‘on the ground’, and can ensure arrangements are flexible and responsive to local circumstances, while the Australian Government ensures that all Australians, wherever they live, have equitable access to quality services.
- This is the only way that all the States can ensure that the model would work for them and their specific conditions and arrangements.
- All governments will be politically accountable for their roles and responsibilities, including their respective funding of the new system, and hence must shape the directions and arrangements.

It is not, however, essential that all the States *implement* an integrated health care system within the same timeframe. Within an agreed overall national framework, the Australian Government and each State could negotiate phasing and other details to suit that State’s circumstances — some ‘early adopters’ may thus complete the integration process while others are still in transition.

Regional Health Agencies

RHAs would be responsible for the health of all residents within a defined geographical region. They would purchase services from providers for their populations, develop accountability arrangements and monitor performance.

The RHAs would be accountable to and report to both the Australian and State Governments because of the joint funding responsibilities. This could be, for example, via an integrated board of governance.

Health care providers

As is the case under the current health care system, most health care would be delivered by private sector providers (including not-for-profit providers), with the main exception of public hospitals, for whose performance — as key providers — the State Government would remain responsible. But all health care providers, including public (as well as private) hospitals, would be accountable to the RHAs through the service agreements.

4.6 Summary of conclusions

The key aims of health reform outlined in this paper are to improve:

- affordable access to quality care and the continuity of care;
- the interface between primary, acute and aged care and the degree of focus on prevention, health promotion and disease management; and
- incentives for primary providers to provide more cost-effective care and reduce the need for acute care.

The paper has argued that in our federal system, while it is necessary to have a *consistent national framework* within which the Australian and State Governments play their roles in health care, the ways in which health care is organised and delivered can vary in the detail across States to suit local circumstances and local community priorities. Indeed it is a strength of federal systems that the diversity they allow is particularly conducive to policy innovation and service improvement.

As a number of previous studies have argued, the key broad direction for reform is *integration* of federal and state health care programs through *funds-pooling* and *budget-holding* — implemented to suit each States' circumstances within that national framework.

The formation of a joint federal–state national body, the Australian Health Commission, is envisaged as the essential first step to drive the reform process. The AHC would report to the Federal and State Health Ministers. Its first task would be the development of the framework for an integrated health care system. Under that system, regional health agencies (which could be based on existing entities such as the health care networks of State Health Departments) would control a budget of *pooled* federal and state funds for acute, primary and community care, pharmaceuticals and aged care. This approach has many advantages:

- By giving the long-term, continuing responsibility for the health of all residents within a region to a single authority, there would be greater emphasis on improving the health status of that community, and increased capacity and incentives for continuity of quality care and service integration.
- Planning could be undertaken across lifetime health problems and needs, disease stages, populations and modalities of care. Possibilities for substitution between more and less cost-effective interventions would be maximised.
- There would be incentives for appropriate cost containment, including through possibilities for substitution between more and less cost-effective interventions.

There is a strong case for beginning the move towards an integrated health care system with reform to primary health care, and the foundation for better-integrated care for people with continuing care needs is their enrolment with a GP practice taking overall responsibility for care coordination and service integration.

Each State could progress to an integrated health care system within its own timeframe and subject to detailed negotiations. However, this would be done within broad directions and a national framework agreed between the Australian Government and all the State Governments.

5 Directions for health reform in Australia

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5.1 Introduction

The views in this paper are mine, and do not necessarily reflect the views of the Australian Government.

Firstly, I describe the nature of health systems before presenting a brief overview of the performance of Australia's system. This assessment leads to my list of good system design principles and the key structural issues we need to address.

The paper then examines in more detail from my own experience federal-state relations, the main focus of this Productivity Commission roundtable, before setting out my views on the direction for reform, both longer term and more immediately. In doing so, I will also comment briefly on some of the options and suggestions set out in the Productivity Commission's Review of National Competition Policy Reforms (PC 2005f).

5.2 The nature of health systems

We all talk about health systems, but health is as much an industry as a system. In most countries, and certainly in Australia, health is certainly not a centrally designed, or hierarchically managed system. It is huge — around 9.7 per cent of GDP in Australia — and participants, both consumers and providers, exercise a considerable degree of independence.

The health system nonetheless is dominated by government, as funder and regulator, and frequently as provider.

Considered as a system, health has four key objectives (DHAC 1999a):

- the *good health* of citizens, though of course this objective relies on much more than the health system;
- *equity*, enuring services are available according to need, and are paid for according to capacity to pay;
- *low cost*, or value for money; and
- the *satisfaction* of the various participants — consumers in terms of access, quality, effectiveness, courtesy, and so on; providers in terms of the support the system gives them to apply their professional expertise and in providing reasonable remuneration; and funders in terms of returns on investments.

Governments inevitably play a large role in health systems (DHAC 1999b):

- Some of these objectives, particularly equity, require government action to redistribute resources according to need.
- Health also contains public goods and involves externalities, particularly in the area of prevention — immunisation, food safety, drug safety and efficacy and so on.
- Information asymmetry and market failure in health are significant:
  - most important in my view is the moral hazard problem of any insurance arrangement, where consumers and providers will inevitably take advantage of a third party payer;
  - in health this problem is exacerbated by the scale of technology advancement and the influence of doctors: it is not easy for third party payers to constrain doctors from providing the very best of care just because it costs too much; and
  - the risk of adverse selection also requires government intervention such as through regulation of the health insurance industry.

Governments do not always intervene successfully of course, and those interventions also always involve costs. The World Bank (Musgrave 1996) has offered some simple but useful advice about government involvement in health:

- Governments *should not*:
  - finance health systems in a way that makes the poor subsidise the health care of the rich;
  - tie public finance to public provision, but separate purchasing decisions from providing decisions;

  - pay on a fee-for-service basis unless there are other mechanisms to control expenditure; and
  - simply finance whatever people demand when care is free: some limits to services and/or some cost sharing are essential.
- Governments *should*:
  - use each less intrusive intervention to the point where a more intrusive intervention is justified, with the sequence of intrusiveness being inform, regulate, mandate, finance and provide services;
  - stimulate competition in the provision of health care;
  - place as much of the incentive for cost containment on the supply side of the market, rather than on consumers; and
  - deal with government failure by promoting more skill and understanding and by fewer barriers to efficiency.

Another important aspect of health is the role of professions and beneficent organisations. This was highlighted by Arrow (1963) in the 1960s, but it is still relevant today, despite the massive increase in private investment in the health industry around the globe. We still expect health providers to act in the interests of patients even where that is not obviously in their own self interest. This in turn imposes some constraint on the free market in health, and on the capacity of government to direct: it places some emphasis on collaboration, a term viewed with some suspicion in markets (and in government), and on professional standards and community values.

All this leads to some limits on the appropriate role for competition in health systems. But this too can be exaggerated, as competition may not only improve efficiency but also ensure services are more responsive to individual requirements and preferences.

The role of competition and choice is most important amongst providers of care, most obviously at the first point of contact with the system, the general practitioner. Competition amongst referred specialists tends to be constrained by the reliance of patients on GPs, and GPs' tendency to have particular networks for referrals (though there are ways to ensure patients and their insurers have some say including over price). Competition amongst hospitals is also constrained where safety, quality and economies of scale require concentrations of expertise and high cost infrastructure. Nonetheless, there is significant room for competition amongst those providing scheduled or planned services, and amongst those providers in the larger metropolitan areas. Similarly, there is significant room for competition and choice amongst providers of community aged care services including residential care. Even

without direct competition skilled purchasing can improve transparency of costs and performance and encourage improvement.

Governments may also use competition for accessing medical benefits both to contain costs and to ensure access, as has been done for selected rural services, or they may use broader purchasing agreements with provider organisations, which may set other conditions to improve service quality and effectiveness as well as contain costs and improve access. While the evidence (Musgrave 1996) is that competition amongst funders yields fewer efficiency gains than competition amongst providers and requires careful regulation (for example to stop 'cream skimming'), it may reinforce competition amongst providers, and open up greater choice for consumers particularly where consumers are willing to make additional contributions towards financing their healthcare. If however, the private funds are unable to manage their 'moral hazard' problem, and impose adequate constraints on medical services and costs, there are risks for the efficiency of the health system overall.

Private contributions play an important part in health systems, and, with inexorably rising community expectations and pressure for choice, they are likely to become more important:

- Copayments may limit the moral hazard problem and, with appropriately designed safety nets and means tests, need not be inconsistent with achieving equity.
- Private health insurance contributions can also help to balance the health system, allowing those who wish to contribute to get around some of the necessary constraints applying in the publicly funded system such as queues, limits on service provider choice and limits on amenity of service. So long as the publicly funded system is of high quality with good access on the basis of medical need, the even better service available to those making additional private contributions is not, in my view[1], inconsistent with the overall system's equity objective. Indeed, to the extent the services covered would otherwise be provided by the public system, there is a case for government support. But care is needed to ensure that any such support does not end up involving higher total government funding for privately insured people than for the uninsured.

In this huge mixed system with many players exercising different levels of independence, a key question is who is best able to manage what risks. This relates particularly to the roles and responsibilities of different levels of government which

[1] Others have different views, and the Canadian system has excluded private financing, including private insurance, for services covered by Medicare.

I will discuss in more detail shortly. Let me now simply make some general remarks.

- The subsidiarity principle, often cited by the Productivity Commission (see, for example, IC 1996), is a useful theoretical guide (it was originally used by the Catholic Church in the middle ages), suggesting that decision making should be at the lowest level possible consistent with communities of shared interests in the relevant decisions. An important corollary is the desirability of both revenue-raising decisions and spending decisions being at the same level.
- The subsidiarity principle would still justify a substantial role for the national government in health:
  - first, because equity is such an important objective, and equity is generally accepted as a national responsibility in Australia (as illustrated by social security and Grants Commission arrangements);
  - given modern transport and communications and the way people live and travel, a national role is also increasingly important in regulatory arrangements (for example relating to food and drugs, quarantine, and health insurance);
  - economies of scale also demand national involvement in such areas as listing and pricing drugs and services on the basis of cost effectiveness, information infrastructure and standards, guidance on clinical good practice and the provision of some specialist services; and
  - in any case, the Constitution (section 51(xxiiiA)) provides the Australian Government with power to make laws with respect to sickness and hospital benefits.
- Another framework that may be considered largely in conjunction with the subsidiarity principle involves distinguishing between funders, purchasers and providers: this distinction of *roles* may allow some blurring of the distinctions between *responsibilities* in order to best manage risks:
  - a high level funder could define eligible services, set certain prices and define good practice without determining the quantity or mix of services;
  - purchasers could determine the quantity of services and decide on the allocation of funds between different service providers (the actuarial evidence is that purchasers could cover most variations in health risk if the population they are responsible for is around 200 000 or more (with their funds adjusted for the age/sex mix)); and
  - providers could be local, regional or national, depending on the economies of scale involved, with capacity for local community involvement in many cases. They might accept all the management risks involved in delivering the

outputs (and possibly some outcomes) determined in the agreements with the purchasers.

- A framework which is increasingly inefficient is one which separates funding or purchasing responsibilities on the basis of types of care — primary care, acute care, long-term aged care and so on. While such different services catered for different people, or involved distinct episodes of care with limited interaction across the boundaries, efficiency could be addressed primarily in a technical way within each functional area, and GPs and specialists relied upon to help patients navigate their way through the system. But modern technology and the increasing importance of chronic disease and frail elderly people, mean that allocative efficiency is of greater concern today than just technical efficiency, and funding boundaries based on types of care may not only cause inefficiency but seriously undermine the effectiveness of the care provided. For individuals needing ongoing support, to receive appropriate services seamlessly across the system also requires a strong locally-based primary care system.
- This does not imply doing away entirely with distinctions between types of care. Health professionals, administrators and financial controllers all rely heavily on the experience and expertise they have developed within the various categories of care, and purchasers increasingly rely upon sophisticated techniques to promote efficiency and cost-effectiveness within these different categories. But in doing so, it is also increasingly important to use clever ways to shift funds across these categories to achieve the best health results for individuals.

My final point about the nature of health systems concerns the process of change.

- Health is forever changing, particularly under the influence of new technology: amongst the key challenges for policy makers are to ensure the system has the necessary flexibility to adjust to the changes, taking maximum advantage to improve health at lowest reasonable cost, and also to ensure that the many interests in the system are not able to exploit changes at the expense of consumers or those financing the system: external vigilance is not only the price of peace but also the price of a good health system.
- Health is the only area of government policy I know which impacts on every individual directly and personally, and accordingly it is always high on the political agenda, at every level of government — you cannot take politics out of health decision making.
- Boundaries are inevitable, both within the system (for example between a hospital and a nursing home and a general practice) and between health and other closely related policy areas such as community welfare, education, housing and law enforcement.

- We can look to remove the boundaries that are counterproductive but we must also focus on leadership and transparency and a culture that fosters positive engagement across the boundaries that must remain.
- In Sid Sax's (1984) *A Strife of Interests* where there is limited scope to direct the system, incentives are important as well as leadership, transparency and collaboration.
- Major policy or system changes take time, require extensive consultation and negotiation and involve significant costs.
- The extensive role of government, and the limited role of the market, means national health systems are closely related to each nation's history, institutions and culture — there is no single model of best practice, and changes have to suit local conditions (Marmor 1995).

5.3 System design principles

From this elaboration of the nature of health systems, I suggest there are a number of principles or themes that should guide future reform.

First, the national government should accept the leadership role in setting the overall design principles of the system, and monitoring its performance, but there must be some flexibility in the system at a lower level, lower than most of our States.

Second, the system should remain a mixed public and private one:

- with governments concentrating primarily on regulating, funding and purchasing;
- with service provision being primarily private or charitable;
- with increased competition amongst providers and increased sophistication amongst purchasers;
- there is an important role for private health insurance, and potential for the role to be broadened, but there are also strong caveats including the need for careful regulation, and recognition that the efficiency gains from competing funds may be limited; and
- there is also an important role for copayments and private contributions, particularly if greater choice is to be allowed into the system.

Third, there are major advantages in moving towards single funder and/or single purchaser arrangements, whatever federal arrangements are in place, with funds

following patients rather than being defined by strict functional or jurisdictional boundaries.

Fourth, such a single funder or single purchaser system is likely to give weight to primary care support, including continuity of care for those who need ongoing services across the system.

Finally, given the limits to structural solutions and to the pace of reform, attention must also be given to people issues such as leadership and collaboration, and supporting systems and processes such as better information and transparency and genuine consultation.

5.4 Australia's performance

While it may be common knowledge amongst this audience, it is still important to remind ourselves that Australia ranks highly on a number of indicators of system performance:

- Australia ranks third amongst comparable OECD countries for life expectancy, sixth for healthy life expectancy and third in overall health system effectiveness (AIHW 2004b; OECD 2004);
- relative to Canada, the UK and the US, a higher proportion of Australians see a doctor promptly when they need to, and rate their care as very good or excellent (Schoen et al. 2004);
- waiting times for emergency departments are shorter than for the US, Canada and the UK (Schoen et al. 2004); and
- waiting times for elective surgery are shorter than for Canada, NZ and the UK (Schoen et al. 2004).

Our biggest failure is in regard to Indigenous health, where life expectancy is up to 20 years lower than for other Australians (the latest data (AIHW 2005) suggests the gap may be nearer 17 years now), this gap being substantially bigger than the gap between Indigenous and non-Indigenous peoples in the US, Canada or NZ.

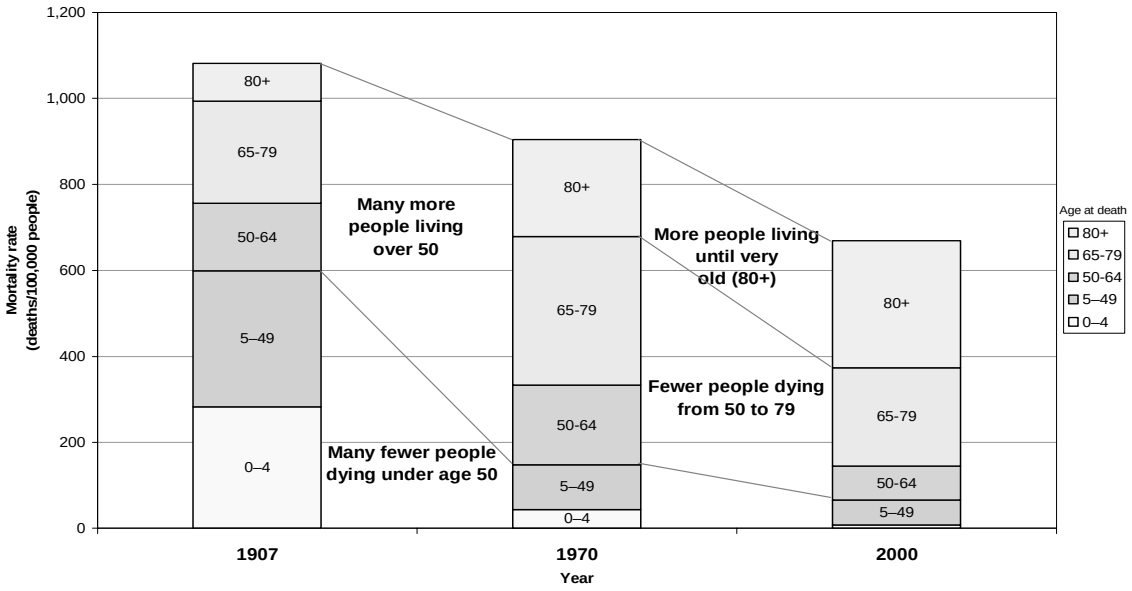
While mortality rates for most major specific diseases are declining, the prevalence of some diseases, particularly diabetes and obesity, is on the increase.

Nonetheless, apart from Indigenous health, our biggest challenge is to address the impact of our major successes, the fact that people are living a lot longer today, and are not dying so rapidly after heart disease and cancer.

The following graph (figure 5.1) illustrates our success — which is mirrored amongst other developed countries:

- the increase in our life expectancy from 1900 to 1970 was dominated by our success in reducing child mortality and mortality amongst others under 50, so that many more people reached the age of 50;
- but the increase in life expectancy since 1970 has been dominated by our success in ensuring those who reach age 50 live a lot longer on average after that point;
- our life expectancy is still increasing at around 3 or 4 months every year; but
- one of the impacts of this is that we have many more frail aged people, and we have many more people who have survived the onset of heart disease or cancer or other diseases, but require some ongoing care regime to ensure they can live with reasonable independence and quality of life.

Figure 5.1 **Changes in mortality rates, 1907 to 2000**



The AIHW (1999b, 2002b) has estimated that about 80 per cent of the burden of disease in Australia is now related to chronic disease. The question now is how well our health system performs in managing chronic disease, and the needs of our increasing numbers of very frail aged.

There is clear evidence (AIHW 2004a, 2004b) that we could do better:

- we have a high rate of potentially avoidable hospitalisations for chronic conditions, particularly amongst those with diabetes of whom only one in five receive best practice ongoing care;

- we do not manage the frail elderly who need some hospital care very well, and too many of them go to hospital too often. Step down and rehabilitative care has been substantially cut in the last decade or so and, while hospital stays per 1000 people over 75 have increased around 40 per cent over the last 10 years, the number of bed days has declined by 10 per cent;
- State Government claims of around 2000 elderly people in hospitals who are awaiting residential aged care is about right;
- despite improved incentives for GPs to coordinate care plans for the chronically ill, the take-up of the relevant MBS item has in fact fallen off a little, and there is very patchy support for those patients needing allied health care and advice; and
- increasing obesity and diabetes in Australia suggests also that we may be under-investing in preventive health strategies.

Popular perceptions of the performance of our health system do not generally focus on these issues, but on problems of access to urgently-needed care, particularly hospital services, and there is evidence — see, in particular DHA (2005) and also DHA (2004c) — to support some of the claims of deteriorating performance:

- waiting time for admission to hospital from emergency departments is frequently very high — 19 per cent of patients admitted from emergency departments in Victoria waited more than 12 hours last year, and 25 per cent in NSW waited more than 8 hours; a one-off survey of 82 hospitals last year revealed more than 80 per cent of those awaiting admission had been waiting more than 8 hours;
- despite some State Government claims, this is not due to more GP-type patients turning up in emergency departments, but to increases in the number of serious presentations and the unavailability of hospital beds;
- hospital occupancy levels have increased to around 85 per cent on average, a level the Australasian College for Emergency Medicine (ACEM 2004) claims is likely to lead to overcrowding in emergency departments;
- major improvements in productivity allowed substantial reductions in the average length of hospital stays in the 1990s and increased private health insurance membership did take some pressure off the public system, but separations per 1000 people more recently has more than offset those gains, meaning there has been a need, particularly since about 2000, for a steady increase in public hospital beds; and
- the proportion of elective surgery patients who were admitted within their clinically recommended time has fallen in recent years and again the main cause appears to be lack of sufficient hospital beds and related medical resources.

I do not want to exaggerate these problems, as Australia performs better in these areas on average than NZ, UK and Canada, we have a relatively high number of hospital beds and hospital separations, and States have increased funding significantly in the last couple of years:

- but I suspect we squeezed the system too far and were too slow in taking into account increased demand;
- nor have we done enough to constrain that demand by more appropriate care outside the hospital for those at most risk.

Another area of common concern is access to primary care, particularly in rural and remote areas:

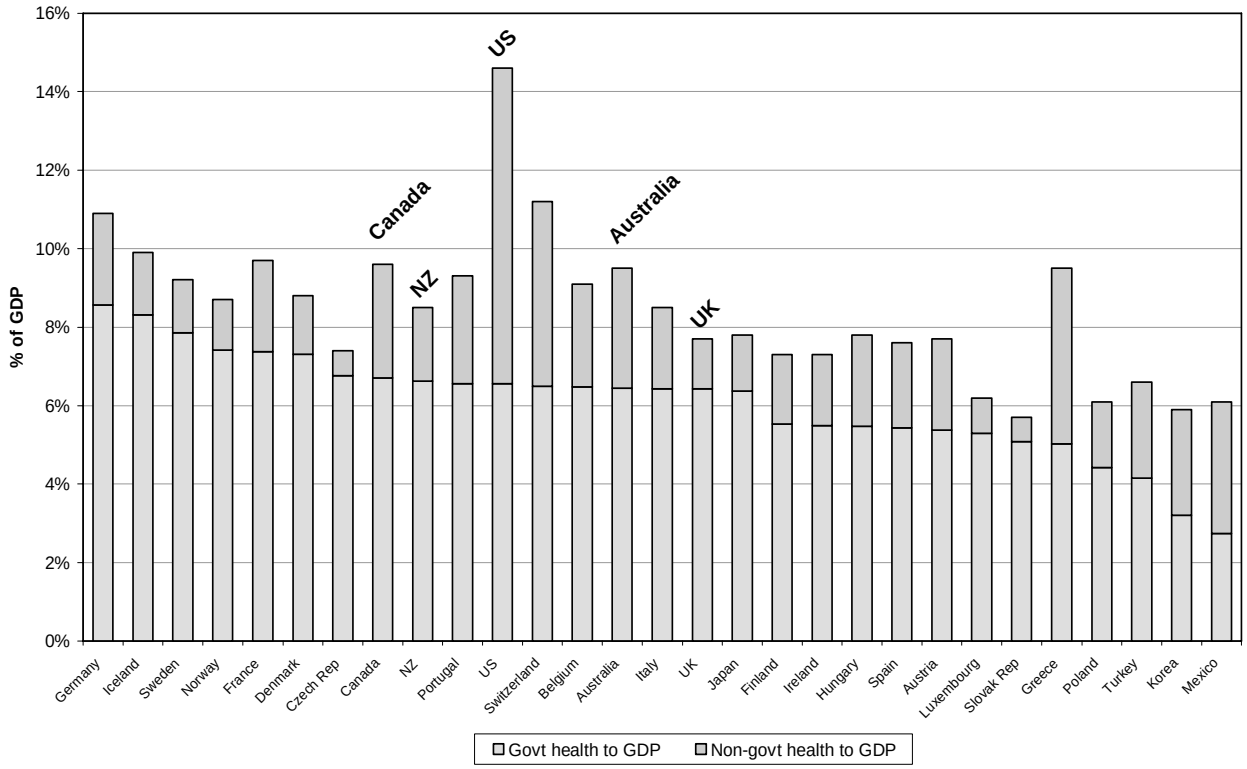
- importantly, there remain significant differences in the ratio of equivalent full-time GPs per 1000 population in metropolitan, outer metropolitan, regional, rural and remote areas;
- but there have been improvements in the ratio in rural and remote areas in recent years;
- the gap of most concern in my view is the one affecting services for Indigenous Australians, most evidently in rural and remote areas but also, primarily because of cultural obstacles, in metropolitan areas;
- some action has been taken to make up for the very low MBS/PBS spending on Indigenous Australians (37 per cent of the level for other Australians), but a lot more is needed if we take into account relative health needs, and the cost of service delivery in rural and remote areas; and
- the popular focus on bulkbilling rates is generally unhelpful, as it does not clarify who has free access, and who pays what level of copayments — moreover, across-the-board funding to increase bulkbilling is generally very inefficient and its impact short-term.

Even a brief assessment of the performance of our system would be unbalanced if we did not look at the financial side:

- our generally good overall results do come at a price;
- the total cost of our system is now above the average of comparable OECD countries, though our public spending remains below the average (see figure 5.2); the Productivity Commission (PC 2005c) projects growth in the public spending on health (excluding aged care) from 6 per cent to over 10 per cent of GDP over the next 40 years, with public spending on aged care increasing from under 1 per cent to around 2.5 per cent;

- while this growth is due primarily to increased technology and community expectation, around a third or more is due to the ageing of the population:
  - I have some sympathy with the Productivity Commission's line that, while ageing is not the major driver of health costs, it does exacerbate the pressures from technology and community expectations; and
  - put another way, it makes it even more important to manage the problems of moral hazard in an industry where technology is exploding and providers have substantial independence.

Figure 5.2 **Government and non-government health expenditure as a proportion of GDP, OECD countries, 2002**



We have an international reputation for our expertise in applying cost effectiveness requirements for listing and pricing pharmaceuticals, and we are expanding this to medical services. But we should be taking this a lot further in a more coordinated way across the health system (PC 2005e), and there is reason for concern about the capacity of private insurers to apply cost effectiveness controls, and other means of managing both their own costs and the out-of-pocket costs of their members.

We have also had some significant success in using casemix-based purchasing to drive efficiencies in the hospital sector, and our DRG technology has been bought by Singapore and Germany amongst others. There has been reluctance, however, to

extend the use of casemix, or to use more sophisticated purchasing techniques and competition outside the acute care area. Indeed, even in the acute care area, there are significant problems of uneven playing fields and inappropriate incentives for private insurers and public hospitals in particular.

Perhaps the most significant contributor to inefficiency today is not the lack of technical efficiency within particular functional areas such as hospitals or residential aged care or general practice, but allocative inefficiency where the balance of funding between functional areas is probably not giving best value, and the inability to shift resources between the functional areas at local or regional levels and to link care services to individuals across program boundaries is reducing the effectiveness of the system.

The scale of this inefficiency is very hard to measure, but a recent study of Kaiser Pemanente and the NHS suggested that, even between those two systems which both have a single funder, there was a major difference in allocative efficiency (Feachem, Sekhri and White 2002). Despite some dubious adjustments for costs, the study rather convincingly demonstrated Kaiser achieved considerably better results with similar total resources, because they invested significantly more in primary and preventive care and in information technology. The study has certainly been taken very seriously in the UK which is now putting a lot more emphasis on single purchasing, and on primary care and IT. My strong suspicion is that the problem here is probably greater than in the UK, because of our stronger demarcation of programs particularly through having different funders with strong incentives for cost shifting and blame shifting, and the UK's greater experience with integrated purchasing mechanisms such as GP fundholding and primary care trusts.

5.5 The key structural problems in Australia's health system

From this brief assessment of the performance of our system, and the discussion of the nature of health systems and possible principles of good system design, the structural problems I believe require most attention are:

- *the lack of patient-oriented care*, that crosses service boundaries easily with funds following patients, particularly those with chronic diseases, the frail aged and Indigenous people;
- *allocative inefficiency*, with the allocation between different types of care not always achieving the best health outcomes possible, and with obstacles to shifting resources for individuals or communities to allow different mixes reflecting different needs;

- *poor use of information technology*, where better investments and usage could not only reduce administrative costs and costs of duplicate testing and the like, but also support more continuity of care, better identification of patients at risk, greater safety and more patient control; and
- *poor use of competition*, with an uneven playing field in the acute care area, a reluctance to use competition to ensure best access to medical services at reasonable cost, and less choice than should be possible in aged care in particular.

Another important structural issue which I have not focused on in this paper concerns the *health workforce*. Problems in this area are likely to be exacerbated with an ageing population and shrinking workforce, but are already compounded by obstacles to substitution, poor distribution and some old-fashioned workplace practices that constrain flexibility. Addressing the structural issues I have focused on would ameliorate some of the health workforce problems by promoting flexibility, substitution and competition.

5.6 Federal-state relations and options for systemic change

Every one of these structural problems is exacerbated by Australia's division of roles and responsibilities between the Australian Government and the States.

This leads to consideration of options for systemic change to our current division of roles and responsibilities, but in considering such options I must emphasise some of the points I have made already:

- our health system is performing pretty well on the whole;
- changing a system as large as our health system is not costless or without significant risk;
- any new system will still have boundaries to manage, and is likely to involve all levels of government, even if some clearer division of responsibilities can be achieved; and
- any new system must fit with our own history, culture and institutions.

The following four options for systemic change all involve moves towards a single funder and/or single purchaser, in order to address the challenges of patient-oriented care and allocative efficiency better. The options are:

(a) States to have full responsibility for purchasing all health and aged care services;

(b) the Australian Government to take full financial responsibility for the system, as both funder and purchaser;

(c) the Australian Government and the States to pool their funds, with regional purchasers having responsibility across the full range of health and aged care services; or

(d) the Scotton model, or 'managed competition' model, with total Australian Government and State moneys to be available for channelling through private health insurance funds by way of 'vouchers' equal to each individual's risk-rated premiums which the individual may pass to the fund of their choice, the fund then having full responsibility as funder/purchaser of all their health and aged care services.

Option (a) States having full responsibility

The first option could be managed along the Canadian lines with national principles requiring the States to ensure universal access to comprehensive services, and ensuring regular measurement of performance. The States could choose whether to have lower level regional purchasers of services, and might agree to cooperate or to seek the Australian Government to manage certain parts of the system on their behalf where economies of scale demand this for example listing and pricing drugs and medical services, managing the national blood service, regulating private health insurance.

The Canadians have made their system work pretty well on the whole, and it does allow single funding and purchasing across most health and aged care services. But they have also had continuing debate about the 'crisis' in health and about federal financial relations (Kirby 2002; Romanow 2002). There is continual blaming of the feds for under-funding the system and of the provinces for underperforming, and there is a continuing debate about the Medicare principles, particularly around comprehensiveness of care (for example, pharmaceutical benefits are not required by the national legislation), the limited role of private health insurance and whether copayments should be acceptable. There are also ongoing arguments about whether the Australian Government should play a stronger part in oversight of the system, and concerns about the capacity of smaller jurisdictions to manage the system.

Most importantly, however, we need to recognise our different history and experience to that of our Canadian friends:

- while this option might meet the design principles I outlined earlier, I doubt we could easily reverse our history of the last 30 years in particular;

- the option would involve returning to the States the more than two-thirds of the public spending on health now funded by the Australian Government, which amounts to over a third of current income tax revenue;
- it would involve enormous legislative change, and a long and controversial debate about the national Medicare principles, and how prescriptive they should be and how much flexibility should be allowed to the States (for example would the national MBS remain, and would there need to be a specific national policy on copayments); and
- most importantly, there must be substantial doubts about the capacity of the smaller jurisdictions — including SA and WA — to manage the full range of health responsibilities.

One of the advantages claimed for this option is that through 'competitive federalism' it encourages innovation and hence greater efficiency and effectiveness. No doubt examples can be identified of worthy State initiatives, but I am not sure this is the most effective way of promoting innovation. The Victorian introduction of casemix in the early-1990s may appear to support the idea, but it is important to note the substantial investment over a number of years by the Australian Government into developing the Australian DRGs which was a prerequisite for the Victorian initiative; while acknowledging the work then put in by Victoria to operationalise casemix, it is also intriguing that NSW, for example, has continued to resist using casemix for purchasing purposes for another decade suggesting the competitive pressure of federalism can be resisted. Other techniques that may be as effective as competitive federalism to encourage innovation include separately funded national investments such as for casemix, or the former National Hospitals Demonstration Program (which funded individual hospital initiatives with systematic processes for testing and disseminating the learnings). Allowing lower level budget-holders and applying good purchasing techniques can also encourage innovation and improved efficiency and effectiveness amongst purchasers and providers, whether or not a federal approach were adopted.

Option (b) The Australian Government having full financial responsibility

The second option, an Australian Government takeover of full financial responsibility (including both funding and purchasing), is feasible and in my view would ultimately assist in addressing all the structural issues identified earlier:

- it would require a great deal of effort, however, and complementary action to take over State staff and facilities and establish new administrative structures

which allowed for regional and community level flexibility and input, and enabled more sophisticated purchasing;

- it would require renegotiation of the GST agreement with the States, and a return to the Australian Government of an increasing share of the GST given that health spending by the States is increasing faster than the economy as a whole (federal — and total — health spending is also growing faster than GDP);
- it would, nonetheless, get rid of most of the cost shifting and blame shifting of current arrangements and, most importantly, allow the national Minister and Department to focus much more on the management of the health system itself and on health outcomes, rather than on point scoring and intergovernmental negotiations (it would also reduce duplication, but I suggest the savings here would be modest, and only a fraction of the gains to be made from improved allocative efficiency).

This last point is not a trivial one by any means. It is hard to see a more likely way to get the national focus encouraged by the Productivity Commission (see, for example, PC 2005e) on such matters as health technology assessment, clinical guidelines and disease management protocols (and health workforce) than to have the national Minister and his department responsible financially for the whole system.

While some may dispute the point, this option arguably satisfies the subsidiarity principle, recognising that equity requires national direction, as does much of health industry regulation today, and recognising economies of scale. It avoids the vertical fiscal imbalance involved in the first option, and could allow for local community responsiveness through regional planning and purchasing processes and local provision of services.

Option (c) Federal-state pooling

The third option of pooled funds has been promoted in the last year or so by Victoria (Allen Consulting 2004a), and was the focus of the 1995-96 CoAG deliberations (CoAG 1995). It sounds as if it would involve less dramatic change than the first two options, but my experience suggests that is not so.

- In 1996, with a new conservative Government with a policy platform espousing reform of federal relations, with enhancement of the role of the States, I encouraged the Government to pursue the reform directions that had been canvassed by CoAG and its officials:
  - the Australian Government offered the States and Territories, as a first step towards pooling and a single State-based purchasing arrangement, the

transfer of all responsibilities for aged care subject to a funding agreement to be negotiated;

  - this offer was rejected by every one of the States and Territories before any serious discussion of a possible funding arrangement took place;
  - to me, this was a watershed: if we could not move an inch towards a funding agreement on aged care, that would allow the States to be the single purchaser of both aged care and acute care, the prospects of a deal on the bigger ticket items of the MBS and PBS seemed to me to be extremely limited .

- My experience with the 1998 Australian Health Care Agreements made me even less optimistic of the chances of the old CoAG model:
  - that agreement included provision for what we called 'measure and share', a flexibility to negotiate bilateral deals where a particular targeted transfer or pooling of funds and risks would lead to measurable gains that could be shared;
  - in the five years of that agreement we were able to negotiate only one deal with one jurisdiction involving the transfer of funds from the Australian Government to Victoria in exchange for them providing appropriate prescription drugs for outpatients and those on discharge from hospital, a responsibility States had effectively cost-shifted to the PBS and the Australian Government over the previous decade with significant cost to efficiency of the health system as a whole, and to safe and effective care of patients;
  - I had hoped 'measure and share' would lead to substantial reforms at the boundaries of acute care and primary care, and of acute care and aged care, with the PBS change so obvious it should have been sorted out in six months.
- On the other hand, the Coordinated Care Trials (DHA 2001) confirmed for me that a single funder/purchaser could indeed ensure more effective care, though it also demonstrated again how hard pooling was.
- The greatest success we had in pooling was for the Indigenous Coordinated Care Trials — here pooling was very tightly targeted on communities where there was no argument over priorities, and the Australian Government offered significant additional funds;
  - wider pooling, for a longer time and without substantial growth moneys from the Australian Government is another proposition altogether.
- Another lesson from that Australian HealthCare Agreement was that reliance on output and outcome targets is not sufficient. Without some agreed commitment

from the States as well as the Australian Government on the financial inputs, there is serious risk of game playing on the data on outputs and outcomes;

– the 2003 Agreement has been more successful both in compelling the States to provide timely and audited performance data, and in ensuring they meet minimum financial commitments (and indeed, they are well ahead on those commitments).

All this makes me very wary of the capacity to negotiate the pools of funds and the sharing of risks associated with this option. I would be very concerned about the probability of political paralysis as decisions on resource allocation would require either bilateral or multilateral agreements (unless more authority is given to the regional administrators than I suspect the politics of health would ever permit).

Option (d) Managed competition

The fourth option, the Scotton model, has considerable theoretical elegance:

- a single funder for any patient's care;
- scope to increase competition amongst funders as well as providers; and
- increased choice, of funders and providers, with capacity through private contributions to sign up to the insurance cover the individual would prefer.

Of course, I am also aware of the uncertain impact of some of this extra competition given the limited capacity of private insurers to manage the levels and costs of the services doctors provide. Nonetheless, if combined with retaining the option for people to select a government purchaser, there are real attractions to this model.

At this point, however, it remains a theoretical model, not a practical option for us today:

- not only would substantial work be needed to calculate the risk-rated premium for each person to use as their voucher, but some way of getting agreement between the Australian Government and the States would be necessary to pay the premiums: I cannot see this happening other than via the Australian Government taking full financial responsibility first;
- in addition, the model would involve major changes to health insurance and hospital regulation, and substantial upgrading of the capacity of funds to handle a wider range of purchasing responsibilities and the management of the health of their members;
- finally, I doubt the political feasibility of the option, at least over the next few years: it would undoubtedly be seen by some as the end of Medicare, or the

beginning of the end of Medicare, even though it would retain publicly funded universal health insurance.

5.7 Federal-state relations and options for incremental improvement

Clearly, my preferred option for systemic reform is the Australian Government taking full financial responsibility:

- it is feasible;
- but the change would involve costs and risks and a lengthy transition; and
- to achieve gains in performance, it would need complementary action to establish regional purchasers, to set up regional budget arrangements with the necessary flexibility and accountability, to improve primary care, to review aged care arrangements, to establish a national framework for pricing acute care services and so on.

So, while hoping that the Australian Government financial takeover option is pursued more seriously in future, I can understand the caution about it right now, and the attraction of moving on some practical, incremental changes that would be needed anyway if there were an Australian Government takeover.

The CoAG resolution in June suggests that a number of the priorities I would press are being seriously considered. I hope so. My priorities can also be viewed as the natural next steps after the many initiatives by the Australian Government and some of the States over the last five years or so. Interestingly, while I do not now support the pooling ideas advocated by Vince FitzGerald (Allen Consulting 2004a) and John Menadue (see, for example, Menadue 2000) and CoAG in 1995-96, there is a very great deal of common ground about the priorities for incremental reform.

First, on primary care I believe there is further to go in strengthening general practice, and linking it better to allied healthcare, so that it is able not only to help with care planning for the chronically ill and frail aged, but also to deliver on those plans. There is also room for general practice to play a larger role in prevention through assessments and advice for those most at risk.

- The Australian Government is in a good position to move on this consistent with its responsibilities for the MBS and PBS, and it has already taken some important steps in this direction.[2]
- But some mechanism for consultation particularly at the regional level would be advisable if the Australian Government initiatives are to complement (and not replace) the work some States have been undertaking in the area of community health services and hospital outreach to deliver better care for the chronically ill and frail aged, and reduce their hospitalisations.
- Whatever is done in this area, further substantial investment in primary care for Indigenous communities is essential.

Second, and related to this, the federal-state work on electronic health records and other IT support needs continued priority over the next few years, particularly to support continuity of care for the chronically ill and the frail aged.

Thirdly, there is scope to make some important, if incremental moves, towards single funder, funding-follows patient approaches for the frail aged.

- I am not referring to Medicare Gold, which in my view confuses the two issues of federal-state responsibilities and public-private roles, by suggesting the Australian Government could and should take over full financial responsibility from both the States and the private health insurance industry for the aged. (Medicare Gold is hardly an incremental option in any case — given the proportion of State health expenditure directed to the aged, it would be just as easy for the Australian Government to pursue my preferred systemic change option and become fully financially responsible.)
- But the Australian Government already has the lion's share of responsibility for non-acute health and aged care services for the aged.
- The pooled HACC funding in fact adds extra boundaries, with inexplicable overlaps and confusions with Australian Government aged care packages in particular.
- Also the States do have a legitimate beef about people in hospital already assessed as needing residential aged care.
- If the Australian Government had direct financial responsibility for both assessing people for ongoing aged care, and for providing that care, a much more seamless, patient-oriented approach could be introduced, albeit there would remain the funding boundary between acute care and aged care.

[2] Including in particular the introduction of the Enhanced Primary Care item, support for practice nurses and the More Allied Health Services program in rural areas. See also the announced plans to strengthen the role of Divisions of General Practice (DHA 2004a).

- Broadening Australian Government financial responsibility in this area would also speed up the implementation of the reform agenda for community care and ageing-in-place set out in Government policy statements last year (see, for example, DHA 2004b), and would allow the Australian Government to consider seriously the longer term reforms set out in the Hogan Report (Hogan 2004) to enhance choice and competition in aged care.

Fourthly, there is a strong case for further investments into preventive health, focussing on the major known areas of risk from lifestyle: smoking, obesity, nutrition and physical activity. Again, there have been useful initiatives in recent years by the Australian Government including in collaboration with the States, but I believe more could be done particularly via targeted investments directed to geographic areas of most concern and bringing together those in the relevant communities with greatest influence over the behaviour of the targeted groups.

Fifth, I would like to see some further action to improve competition in the acute care area in particular, and to clarify a sustainable role for private health insurance in the Australian system:

- Achieving an even playing field for competition for acute care services for private and public patients will take some time as the issues involved are very complex. But a first step would be to introduce into the next Australian Health Care Agreements something akin to CoAG's competition policy applying elsewhere, particularly to require purchasing on the basis of casemix in a way that removes artificial incentives for public hospitals to press people to 'go private' and to apply charges that do not reflect the full cost of care and encourages States to purchase services for public patients from private clinics and hospitals where it is cost effective to do so.
- In the longer term, there is a case for requiring private health insurers to pay for all acute care services for their members, removing incentives for funds and their members to shift more of the costs to the public system (this would require a series of financial adjustments to avoid increases in premiums), and for removing the default benefits. But in the meantime action could be taken to limit the capacity of the funds to offer products that leave members clearly reliant on the public system for a range of health risks.
- Insurers are currently unable to fund acute care services outside hospitals, and hence have limited capacity to ensure the most cost-effective care of their patients. While a wide expansion of service coverage might raise many of the problems of the full Scotton model, a more modest expansion allowing funds to cover services that could be part of an admitted hospital episode, or substitute or reduce the need for admitted hospital services, would enhance the quality of health insurance.

- The success of this last suggestion is dependent on making the private health insurance market more competitive, where a fund is properly rewarded for improvements in productivity and so on. This requires changes to the rules governing the re-insurance pool — changes which have been canvassed for some years now but which the industry needs to accept.[3] It would also be assisted if there were greater transparency in the industry about products, rules, premiums, and performance, that might influence consumers particularly if a brokerage service emerged.

These proposals would firm up the role of private health insurance in Australia as offering an alternative (for those willing to make an extra contribution) to much if not all of the acute care services available through Medicare's public patient arrangements, with greater choice of provider and the opportunity for earlier access to elective services:

- It is this role which provides the justification for financial support for the industry whether by way of the current rebate or previous subsidies to the re-insurance pool or to private hospitals.
- The level of subsidy justified is a matter for political judgement, but there is a limit if the health system is to meet its equity objective. There is reason for concern that the PHI rebate, together with access to MBS and PBS and continued use of some public hospital services at no cost to the insured person, involves total government assistance close to that available to people who are uninsured.
- There is a growing case for containing the open-ended rebate, by limiting the services for which it is available, and/or by capping it in some way.
- Similarly, there is a growing case for reviewing the Medicare levy surcharge arrangement.

This role for private health insurance is similar to the mixed model outlined in the Industry Commission's report (IC 1997) on private health insurance some years ago:

- I believe it is more suited to Australia's history and to the desire of Australians for considerable choice within a universal system than either the residual role of PHI in the UK and Canada, or the primary role of PHI (other than for the aged) in the US; and

[3] Government proposals for a risk-based capitation approach to the reinsurance pool have been on the table for some time but have met with resistance from the Australian Health Insurance Association. On 26 September, 2005, the Government advised in a circular to industry that it would undertake a review of its proposal and alternatives including from the Association.

- it just might, sometime well into the future, transform into the theoretically elegant Scotton model.

While this agenda of incremental measures would go a considerable way to address the structural problems I outlined earlier, they would still leave both levels of government directly involved in the health system with the risks associated with program boundaries and separate funders.

If this environment is to continue for some time we do need to have systems and processes that allow the boundaries to be crossed easily in the interest of patients and communities, which is the focus of my sixth area for important incremental reform. An important element is information and transparency:

- I would like to see information published regularly on expenditure, service utilisation and population health for each region, using agreed definitions of regions;
- this information would be of great assistance to Divisions of GPs, other providers and planners and administrators from the Australian Government and the States, and could influence resource allocation within the region even with the current division of responsibilities;
- it is the very thing the Australian Government would need to support better resource allocation were it ever to be the sole funder;
- in the meantime, coupled with some shared planning for primary care, involving the GP Divisions, it would represent a major step forward;
- apart from facilitating improved resource allocation within regions, it would also highlight differences between regions, and support measures for more equitable and effective resource allocation across the country;
- some years ago I suggested the concept of 'notional regional health budgets': that now sounds too much like pooling, but regional health services reports including expenditures by all jurisdictions seems to me a modest but very useful idea.

I also included in my list of system design principles the need for good people management — leadership and collaboration. This is particularly important if we are to continue to have both levels of government responsible for substantial aspects of the system. There is considerable room to improve dialogue and trust, but the politics involved does make it difficult. Nonetheless, there are some things I think we could consider.

One idea my attention was directed to a few years back was from a Canadian (Smith 1992) which he termed 'control, influence, appreciate':

- in fields of shared interest, there may be some areas of direct control by different parties, and other areas where one party wishes to influence the other;
- particularly as these various areas may shift from time to time, it is important that each party not only understands what it *controls* and what it wants to *influence*, but also *appreciates* what the other party controls and wants to influence, and why;
- in other words, both parties need to have an appreciation of the whole system, not just their own parts and the parts they most want to influence.

I felt in my time in Health there was too much time spent by both politicians and administrators on politicking, and too narrow a focus on particular programs with not enough time for sound, bureaucratic processes involving good information and serious dialogue to help appreciation of the system as a whole, including by the Australian Government of the service delivery end, particularly hospitals, and by the States of broader issues of financing and regulation, particularly around MBS, PBS and private health insurance.

A related but perhaps more difficult challenge is to improve the professional bureaucratic processes, separate from the political processes. The blurring of these, with some senior State bureaucrats being highly political, made it more difficult to share information and to prepare joint papers that would assist good (political) decision-making by Ministerial Councils and other Ministerial forums.

While I would caution strongly against requiring joint decision-making on everything, and encourage some clearer lines of responsibility, initially in the areas of aged care, I am not an advocate of the Australian Government operating totally unilaterally even in its own areas of responsibility such as the MBS, nor of the States operating unilaterally on hospital purchasing and management: there is an advantage in better information, more transparency and greater appreciation of each other's perspectives and responsibilities, particularly if there is a risk of inefficient resource allocation and less than effective overall service provision.

I am therefore a supporter of the Australian Health Ministers Advisory Committee (AHMAC) arrangements, even if they are sometimes rather cumbersome. There is a case for strengthening the accountability requirements on the States through the Australian Health Care Agreements (perhaps going further than I have proposed above re the use of proper casemix purchasing), but this is not a panacea for real reform as it could not address effectively the most important structural issues of patient-oriented care across the system, and allocative efficiency below the national and state levels. Accordingly, while we retain the current division of funding (and purchasing) responsibilities, it is essential to retain potentially collaborative forums such as AHMAC.

It is also essential to have substantial engagement with the professions, particularly the medical profession, who actually deliver the health services and have responsibility for their effectiveness. Again, better information, more transparency and greater appreciation of each other's perspectives and responsibilities are critical. A particularly successful decision I made while secretary of the department was to appoint an outsider with impeccable standing with the Colleges and the medical research community as Chief Medical Officer (CMO). I am pleased to see that that approach has continued. It has had an enormous and positive impact on relations between the Australian Government administrators and the medical profession, particularly as the CMO was also seen to be close to the secretary and Minister, and influential across the full breadth of departmental responsibilities. Given the increasing importance of clinical guidelines and disease management protocols (based on cost effectiveness as well as efficacy and safety), it is vital to strengthen these links between administrators and professional experts; my impression is that there remain significant problems with current institutional arrangements including the NHMRC.

5.8 Concluding remarks

The incremental reforms I have outlined amount to a pretty substantial agenda with the attraction of achieving practical improvements in services, health outcomes and efficiency.

They are not a totally comprehensive package, for example they assume the States will continue to address the high profile problem of emergency departments and waiting times for elective surgery by more investment into hospital beds, and the Australian Government will press for more cost effective ways of ensuring access to effective medical services including by the use of competitive processes.

And they only indirectly address workforce problems.

But they have the particular attraction of giving health reform a clearer direction, supporting serious consideration sometime in the not-too-distant future of the one systemic reform option I believe is feasible and worthwhile — the Australian Government taking over full financial responsibility — and building some of the infrastructure the Australian Government would need if such a take-over was to achieve the intended gains to patient-oriented care and allocative efficiency. They would also provide more coherence about the respective roles of government and the private health insurance industry.

While I do not support the Victorian proposals for pooling, it is important to recognise how close my suggestions are to those outlined by Allen Consulting, by Menadue and by CoAG in 1995 and 1996:

- with the emphasis on patient-oriented care and allocative efficiency;
- supporting moves towards single funder/purchaser arrangements;
- focussing initially on primary care and on aged care;
- advocating improved purchasing techniques;
- supporting regional administrative structures to allow cross-program flexibility nearer to the community; and
- emphasising integrated patient information systems.

The suggestions would also build on the many good reforms over the last decade or more, particularly around general practice.

There is also considerable resonance between my suggestions and the observations (Allen Consulting 2004b; PC 2005f) of health care reform abroad reported in the Productivity Commission's Review of National Competition Policy Reforms, particularly:

- the focus on controlling expenditure growth and on improving performance of the health care system;
- the greater use of market-type mechanisms and incentives;
- the importance of strong purchasing to drive good value, integrated care, high quality and efficiency;
- market-type measures having a much stronger role in the delivery rather than in the financing of health care; and
- the recognition that good access to primary care can help to control overall costs through health care promotion, illness prevention and better disease management.

Discussant — *Stephen Duckett*

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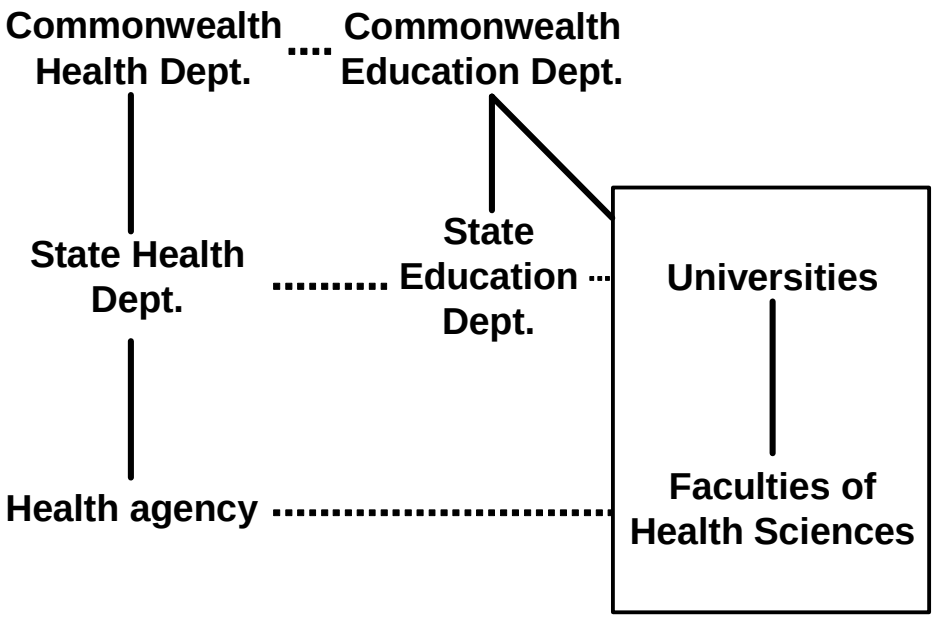
Health care often features in discussions of failures of federalism, and it is no surprise to me that it features as a case study in this roundtable organised by the Productivity Commission. Although it might be argued that the overlap in responsibilities provides the opportunity for vertical competitive federalism, there is no doubt that the current division of responsibilities in the health sector is not acting in the best interests of an efficient and equitable health system.

I will use two examples to illustrate this. First, the current health system in Australia is not well structured to deal with the growing numbers of people who will have chronic illness. In my view the principal problem here is not primarily one of the federal-state division of responsibilities, but rather is that primary medical care practitioners are principally remunerated on a fee for service basis: a system which characterises the interactions between the general practitioner and the patient as being episodic and acute rather than a longitudinal relationship appropriate to people with chronic disease. Primary and secondary care services are also not integrated: in part due to different status and orientation of the two sectors. However, these differences are exacerbated by different funding arrangements and responsibilities: primary medical care is essentially funded by the Australian Government, with acute in-patient services being funded through State Governments for public hospitals or private health insurance, subsidised by the Australian Government, for private hospital care.

These fragmented arrangements mean that no single authority has responsibility for all the care of the person with a chronic illness. A general medical practitioner might, even in the absence of a remuneration incentive, assume responsibility for primary care and care management of a person with chronic illness, but hospitalisations for the patient are the responsibility of other agencies with funding through a different level of government. These funding and organisational arrangements inhibit good care planning and continuity of care.

A second illustration relates to workforce planning, currently the subject of a Productivity Commission review (and discussed by me in Duckett 2005). Although there are technical problems with workforce and demand projections, a critical inhibiting factor is the lack of effective formal structural links between the health and education sectors. Figure B.1 shows the current relationships.

Figure B.1 **Organisational relationships between health and education sectors**



A health agency, for example, relates most closely in organisational terms to the State Health Department. The State Health Department has an overview of the needs of the health agencies within a State and State Health Ministers may be politically exposed to shortages in particular health professions which lead to problems of service delivery.

State Health Departments have two sets of relationships which are of relevance here. One is to the Federal Health Department structured through organisational arrangements such as the Australian Health Ministers' Conference and the Australian Health Ministers' Advisory Council. The other is to the parallel State Education Department. Relationships between State Health and Education departments are not always close and rarely involve structured joint planning arrangements. These somewhat looser relationships are indicated by dotted lines in the figure. The Federal Health Department has links to the Federal Education Department, which in turn has links to State Education Departments and to universities. At the bottom of the figure we note that health agencies have direct relationships with Faculties of Health Sciences within universities, for example, in terms of placement arrangements.

The mechanisms for a health agency or a State Health Department to influence the admission or curriculum decisions of universities are very indirect, typically

progressing up and down the chain, mediated by the Federal Departments. The longer the links in an implementation chain, the more the policies are likely to be attenuated or distorted. The mechanisms for implementing health workforce decisions are very indirect and this could be predicted to be relatively ineffectual, which they are.

The papers before us are from very qualified presenters and based on somewhat similar principles, although the solutions proposed are quite different. Both papers assume that the appropriate principle for allocation of roles is the subsidiarity principle, explicitly cited in Podger's paper. In contrast, there are obviously other principles that also come into play, most notably what might loosely be called a nationhood principle, asking what does it mean to be an Australian and to what extent is nationwide equity about health services (rather than the Growth Commission's concept of potential equity) part of the contemporary psyche of the Australian people.

I am currently undertaking a review of health services in Albury-Wodonga and many people consulted are quite critical of the fact that there are different levels of community services available on different sides of the border. For families who have a chronic illness, it is worth their while to relocate from Albury to Wodonga (or vice versa), although for most people this is not an appropriate strategy. There is a perception that Albury and Wodonga should be regarded as a single entity with uniform levels of service regardless of the State in which a person lives. This perception that it is unfair that there are different levels of community services on different sides of the border seems to suggest that certainly residents of Albury-Wodonga regard community health services as services which should not be differentially provided by different States, but that there should be a common national standard of health care provision.

Turning to the papers before us, Podger identifies four key problems:

- continuity of care;
- allocative inefficiency;
- poor use of ICT; and
- poor use of competition.

He identifies five potential solutions. Only one of these (the development of a single funder for the frail aged) involves solutions which are specifically related to federal-state issues.

Most of the other solutions (improving primary care, development of an electronic health record and so on) could all be pursued without any change to the existing federal-state division of responsibilities.

FitzGerald, in contrast, proposed a much more fundamental restructure of the system. His problem list involves some overlap with Podger's, but the solutions involve a fundamental redesign of federal-state responsibilities through the development of integrated purchasing authorities. Certainly Podger's proposals are more incremental, building on the current arrangements with a toe in the water approach to restructuring. In contrast, FitzGerald is proposing a fundamental rebuild of the health system.

Podger's paper hints about his scepticism about reform, based on his experience as Secretary in the mid to late-1990s. One can deduce from Podger's paper that his incremental approach is based on his perception of the feasibility of change rather than his perception of the size of the problem. FitzGerald in contrast advances a bold new vision but with little clarity about how, and in my view, whether this bold new vision is implementable. Do we have the management skills (either in purchasers or providers) to function in this new environment? We have no evidence that we do, and some evidence that we do not (Willcox 2005). Can we set capitation rates which would stop cream skimming and rent seeking? The evidence we have is that risk adjustment still leaves considerable scope for manipulation (Duckett and Agius 2002). Indeed, Hall has argued that however attractive managed competition ideas are in Australia, we cannot get there from here (Hall 2004).

It is important for us to note that significant minorities of the population could be seen to be living within an integrated system already. Forty three per cent of the population have private health insurance (incorporating both hospital and ancillary insurance) and a further 1 per cent or so of the population is covered by the Department of Veterans' Affairs (DVA) Gold Card. There is now some evidence that the DVA Gold Card system, which provides for an integrated funding arrangement, is providing efficiency benefits: Gold Card holders have somewhat lower use of hospital services than their counterparts, suggesting that the integrated approach and a broad availability of substitute services may act to reduce hospitalisation (AIHW 2002c).

The case of private health insurance is interesting because, *prima facie*, there is a financial incentive on private health insurance organisations to work with their members to improve members' health and reduce hospital utilisation. Health insurance funds are generally not wise purchasers and, although there are some exceptions to this rule, the market has generally not adopted sophisticated preventive strategies amongst their membership (Willcox 2005). Presumably the funds would blame government for this absence, as they tend to blame government

for all their management failings, although a more legitimate argument might be based on high levels of churn in the health insurance industry, which makes long-term investments uneconomic. FitzGerald has not pointed out why that same risk would not apply in his brave new world. Although managed care and managed competition are not identical (the former focussing on provider restructure, the latter on purchaser reform), they share similarities in terms of payment arrangements (capitation) and an emphasis on integration. The United States experience with managed care is mixed (Miller and Luft 1997, 2002) and, for those who think market-type solutions are always welfare enhancing, it is interesting to note that not-for-profit HMOs perform better than their for-profit counterparts on preventive measures (Born and Simon 2001). There is now evidence which suggests that managed care organisations are able to reduce preventable hospitalisations in the privately insured market but not in the Medicaid market, the sicker, poorer part of the population (Basu, Friedman and Burstin 2004). Which experience would be relevant in Australia is not known.

Finally, I will take this opportunity to give my own list of problems and solutions. I agree with the two speakers that continuity of care and treatment of chronic illness is one of the critical issues for the health system, and so too are issues relating to the health workforce (agreeing with FitzGerald here). Other issues that I think are important are the under-investment in capital, patient safety and quality, and to some extent allocative efficiency, although these issues do not primarily stem from problems of federal-state relations and consequentially are not necessarily amenable to being addressed via reforming that mechanism.

In terms of my solutions, I obviously would support an integrated funding arrangement along the lines of Medicare Gold or a pale imitation thereof, and also improvements to primary care, promoting more continuity of care at the primary care level through register-based care, and in this regard obviously I am supporting Podger's approach.

In terms of the workforce, we need to change our conception of federal-state divisions of power and have both increased Australian and State Government responsibility. So, for example, professional registration and the like is now more appropriately handled at the national level, but the States should have a greater involvement in health workforce allocation. A re-division of responsibilities along these lines has recently been proposed by the Productivity Commission in its paper on the Australian health workforce (PC 2005b). With respect to some of the other problems I have identified, I, with Podger, advocate Oliver Twist strategies here: 'Please sir, can I have some more?'.

As wise as the group that has been gathered here is, I am not hopeful that we will identify breakthrough solutions and facilitate major reform across the board in

health care over the next few years. Certainly I think we have some opportunities, but we have had opportunities and missed them over the past decade. The Australian Health Care Agreement in 2008 could presage a new compact on health care, but I am not holding my breath about that.

General discussion

The general discussion for the health reform session focused around:

- the role of incremental versus 'big-bang' reform;
- the scope for competitive federalism in health;
- continuity of care and private insurers;
- charging patients for the use of health services; and
- health workforce issues.

The role of incremental versus 'big-bang' reform

Vince FitzGerald commented that the prepared papers on health reform seemed to differ mainly in terms of the feasibility of making changes. Responding to comments by Stephen Duckett about Oliver Twist and 'the magic of markets', Vince FitzGerald suggested that 'Oliver Twist and his begging bowl' was probably nearer the mark in the world we live in today, but that should not stop us from thinking about the constraints we need to relax to do better. Further, it is not just about the so-called 'magic of markets', it is also about sensible planning and coordination arrangements.

Andrew Podger expressed surprise at being called 'Oliver Twist' as his message was that systemic change is worthwhile. He acknowledged that an Australian Government takeover of full financial responsibilities for health care — his preferred option — could not be achieved overnight. Also, for such a change to be successful, a range of complementary measures — such as shared planning in primary care and improved regional data sets to assist in the planning of health services — would need to be introduced.

A number of participants commented on the dynamic nature of the health system and the demonstrated value of incremental or small-scale reform. One participant suggested that an examination of what is happening at the interfaces of the health system (such as the aged care hospital interface) could provide some 'clues' about changes that could be made to the system without causing some sort of 'Armageddon-like roar'.

Another participant commented that the costs associated with 'big bang' reforms are likely to be large and for this reason it might be more appropriate to ask the narrower question — what are the most dysfunctional and egregious forms of cost shifting', and to work on addressing these. CoAG offered a mechanism for doing this.

While there was some acknowledgement by participants that incremental reforms have produced some worthwhile gains, there was also a sense that much more needed to be done to improve the effectiveness and quality of health care. One participant, for example, alluded to the difficulty of navigating the health supply chain even when there are relatively competent state and federal agencies interacting with local providers. In their view, the system could be improved if a single integrated authority were responsible for the whole chain — from the acute episode through to returning home.

Another participant expressed unease with incremental reform: while it may work, it is often not clear that the community has obtained the best value for the total budget available. Incremental reforms may not yield an appropriate incentive framework for guiding resources within the system. In this context, a single funder across the range of health services, with money following the patient, offers scope for securing greater productivity and efficiency gains.

Vince FitzGerald questioned whether it was fair to characterise all elements of an integrated model as 'big bang' in nature. He suggested that if we concentrated on where the problems were greatest — for example, placing acute and aged care (including residential and non-residential aged care) under the one framework — this was not really big-bang, but would be a useful start towards a more ambitious, wider integration of the health system.

Stephen Duckett, while agreeing that there was scope for incremental reform, suggested that such reform can also be difficult to achieve. He used the example of chronic illness, noting the need for a fundamental rethink about the way primary care is structured. Such a change would involve a move away from a system where primary care is remunerated on a fee-for-service basis, to a system where a general practitioner (or primary care team) takes holistic responsibility for a person with chronic illness.

Scope for competitive federalism in health?

A participant asked the speakers and discussant whether there was any scope for competitive federalism in health care?

Andrew Podger responded by commenting that you do not need federal arrangements to have a degree of horizontal competition. He suggested that if you had regional purchasers there would be scope for competition via service innovation and regions could also learn from each others' experiences. Benchmarking could also be used to encourage competition between service providers. In his experience, a lot of creativity can be gained by holding some money separately and funding particular research or trials.

Vince FitzGerald responded by stating that in almost any system there is scope for 'yardstick competition'. Such competition could be promoted by comparing outcomes and efficiency in service delivery across regions and/or jurisdictions.

FitzGerald was also of the view that we currently have more competition than we need in the vertical dimension, and it is political competition. There are conflicting ideas for reforms which are not properly reconciled. He described times, like the early-1990s, when the Australian Government and States put aside political competition and looked at areas where it would be productive for them to collaborate, as 'magic moments'. FitzGerald urged those who saw a need for reforms to federal arrangements to think about ways in which governments could facilitate discussions directed at improving inter-jurisdictional arrangements and outcomes. In this context, he asked why such advantages were not already apparent.

Stephen Duckett observed that under any of the proposals advanced by the speakers, the States and/or private sector would be the providers of health services, and so there would be scope for competitive federalism.

Continuity of care and private insurers

One participant commented that speakers supported the use of intelligent purchasers to capture various advantages, including improved continuity of care. In this context, he asked why such advantages are not already apparent for the 40-odd per cent of people who have private health insurance?

Vince FitzGerald suggested that churning between private health insurance funds means that it is very difficult under the current arrangements for a fund to internalise benefits such as rewarding people for certain forms of behaviour, such as not smoking. Insurers are also constrained on the range of services they can cover and thereby seek to influence.

Andrew Podger noted that some of the current regulatory arrangements are not consistent with promoting productivity gains by health insurance funds. For example, the re-insurance arrangements spread risks across funds and, as a result,

do not reward the better or more efficient funds. Further, constraints on the range of services private insurers can cover limit opportunities for achieving improvements. He suggested, for example, that there was scope for securing improvements by allowing cover for services provided outside the hospital system where the alternative service was more cost-effective.

Podger noted that while contracting with private hospitals had improved in recent years, private funds still seem to struggle to contract directly with doctors. As in the United States, this appeared to be one of the drivers of increased costs.

Charging patients for the use of health services

One participant expressed surprise that the issue of charging patients for the use of health services had not been raised.

Stephen Duckett commented that we do a lot of this already. He noted that although bulk-billing has attracted a lot of attention recently, we effectively have a compulsory copayment for primary medical care in the sense that almost every primary medical care visit has with it a prescription and there is a copayment that goes with that prescription. Further increasing the patient copayments would have significant equity implications, as the vast bulk of people receiving subsidies under the Pharmaceutical Benefit Scheme are Health Care Card holders or pensioners.

Vince FitzGerald agreed that it would be tricky to protect low-income people under copayment arrangements (for those who can afford it) on a scale that is effective. He noted that the most costly services are the public services which are the first resort of low-income people and, for that reason, a move to high copayments in such areas did not seem consistent with general equity principles.

Andrew Podger saw a role for copayments, noting that some changes in the pharmaceutical benefits area had reduced costs to government without simply transferring costs to patients because they had a demand impact on drug use.

Health workforce issues

Several participants commented that there was no point talking about reform in the health area unless workforce issues were addressed. One participant observed that, at the moment, providers have the ‘whip hand’ because they are in short supply, so any reform ideas would have to be acceptable to them. Another participant noted the extensive variation in workplace regulations across Australia and claimed that there was considerable scope for improvement through the adoption of nationally consistent minimum effective standards and an easing of work practice restraints.

Some participants felt that more thought could be given to the extent to which purchasing of services from doctors could be done, not just on a fee-for-service basis, but where a service is negotiated at a price in exchange for a number of conditions. An example of this involved putting out to tender additional MRI machines and services for rural areas. The best tender was based not only on the price for the Government but on the tenderer's price for the patient. In the view of these participants, there is scope to extend such arrangements to other areas of the health system. Moreover, these arrangements should also be part of promoting more flexible and cost effective workforce outcomes within the system.

PART C

LABOUR MARKET REFORM

6 Labour market reform in a federal system: making the best of a flawed framework*

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> It is clear that no one who set out to determine a rational constitutional system to deal with industrial relations would choose that which we now have.
>
> — *Constitutional Commission (1988)*

> The Government believes that a single set of national laws on industrial relations is an idea whose time has come. In an age when our productivity must match that of global competitors, forcing Australian firms to comply with six different workplace relations systems is an anachronism we can no longer afford.
>
> — *John Howard (2005c)*

For as long as Australia has been a nation, and indeed going back before federation, there has been controversy as to the respective roles of the Australian Government and the States in regulating wages, employment conditions and other aspects of the labour market. The debates over the proposed Australian Constitution in the 1890s resulted in a compromise that saw the Australian Government given only a partial power to deal with industrial disputation. While that power was ultimately accorded a broad interpretation by the High Court, and exploited in ways that would not have been foreseen when it was originally framed, its limitations could never be completely overcome. The legacy of our Constitution has been the emergence and

* This paper was revised after the October roundtable to take account of the contents of the *Workplace Relations Amendment (Work Choices) Act 2005*, which was passed by Parliament in December 2005.

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persistence in each State of parallel and sometimes conflicting systems of regulation.

There have been various attempts over years to address the difficulties posed by this framework. In 1929 the Bruce Government proposed that the federal system be abolished and that the field be left to the States, a move that led to an election at which it lost office. More commonly, there have been attempts to amend the Constitution to give the Australian Government a more general power to regulate industrial relations, or at least key issues such as wages. But on seven different occasions, in 1911, 1913, 1919, 1926, 1944, 1946 and 1973, these amendments have failed at referenda to achieve the level of popular support required under section 128 of the Constitution. Although the Constitutional Commission established by the Hawke Government recommended that a further attempt be made along these lines, its proposal was never even put to a vote in the wake of the disastrous referendum of 1988. There, Peter Reith successfully led a campaign to persuade the Australian people to vote down what might on the surface have seemed a modest package of reforms cherry picked from the Commission's report, including extensions to the right to trial by jury and to compensation for compulsory acquisition of property.

Now it is the Coalition Government of John Howard that has not merely introduced significant changes to federal workplace relations legislation, but expanded that legislation so as to subsume most (though by no means all) State regulation. In his speech to Parliament of 26 May 2005, outlining the thrust of his proposed reforms, the Prime Minister spoke of a national system of regulation as 'the next logical step towards a workplace relations system that supports greater freedom, flexibility and individual choice'. His preference was for this to occur 'in a cooperative manner', with the States voluntarily ceding their powers to the Australian Government. But if this did not occur, he said, the Government would 'move towards a national system by relying on the Corporations power in the Constitution' (Howard 2005c, pp. 8–9). How this is to be done has now been revealed with the passage through Parliament of the *Workplace Relations Amendment (Work Choices) Act 2005*.

In this paper I will seek to explain how it is that we have arrived at our current mix of federal and state regulation, what impact that mix has in practice, and how it will now be altered under the Howard Government's reforms. Much of the paper will be devoted to an explanation of how our regulatory systems have evolved, and of the ways in which our present constitutional framework constrains options for change. While the story is in both cases a complex one, an understanding of that historical and constitutional background is imperative if one is to debate those options. In particular, I would suggest, it is pointless to consider what might be done under a Constitution that gave the Federal Parliament unfettered power to regulate

workplace relations. The reality is that we have a Constitution which is to all intents incapable at present of being amended, at least for any purpose that does not attract broad political consensus. The Australian Government, like other stakeholders, must take the Constitution as it finds it.

Let me offer one further observation before I embark on the history of this subject, and it is one to which I will return in the concluding section. It concerns the difficulty of separating any assessment of what makes for 'good' or 'effective' labour market regulation from the short-term politics of the day. If it is one quality that we as Australians struggle with, in all walks of life, it is taking the long view. Whether it is managing businesses with an eye on something more than this year's profits, or saving for retirement, or urban planning, or our treatment of the environment, or investing in education and training to build a 'smarter society', or capturing the economic benefits of innovation, we seem to find it hard to look further ahead than the next year, or AGM, or election.

And so it is with the labour market. Now I do not mean to suggest that we could ever expect to take politics out of debate in this area. The subject is in every sense of the word a political one, since opinions will inevitably and quite legitimately differ as to the appropriate policies that should be pursued. Even if we accept that we should approach the question primarily from an economic perspective, and ask what types of regulation would best promote efficiency in the operation of the labour market, there will be differences as to the most effective approach. But if we broaden the debate to include the social effects of labour market arrangements, the potential for disagreement is wider still. As the Productivity Commission has noted in its review of national competition policy reforms:

> While it is important that labour market arrangements foster the efficient use of labour and promote participation in the workforce, they also need to recognise that labour is a distinctive 'input' to production, and that wider social objectives and relationships are involved — including the relationships between work, leisure and family, and providing safe workplaces. (PC 2005f, p. 350)

For a good part of the twentieth century, there was a broad if at times grudging consensus amongst most of the key stakeholders in favour of what had become a distinctively Australian (or Australasian) regulatory institution, the fixation of minimum wages and conditions through compulsory conciliation and arbitration conducted by a State tribunal — or indeed by a combination of federal and state tribunals. But that consensus is long gone.

On the right of the political spectrum, what was once an extreme agenda for radical 'deregulation' has now become mainstream Liberal Party policy, at least at a federal level. This calls not only for the dismantling of the existing tribunal system, but for the curtailment of trade union influence over the setting of employment conditions,

in favour of individualised arrangements. Some business groups (see, for example, AMMA 2000) would take this idea even further, by essentially allowing employers to operate as far as possible on a 'self-regulated' basis (for comment, see Murray 2000 and Naughton 1999).

By contrast, those on the centre/left are increasingly concerned not merely to resist such moves, but to undo or at least temper what they see as some of the more socially damaging effects of labour market changes in recent decades: increased casualisation and insecurity, growing inequality in wage outcomes, a reduction of family or leisure time, and so on (Pocock 2003 and Watson et al. 2003). From that viewpoint, the last thing we should be doing is removing laws and processes that seek to protect workers from the lack of bargaining power they typically have in dealing with employers.

The problem though with this divergence of views is that it tends to colour every debate about labour regulation. It becomes very hard to discuss whether we should have a national system of regulation without that being seen in terms of the type of laws we would have now, under a Coalition Government committed to radical reform, as opposed to five, ten or fifty years down the track. Nevertheless, there must come a time to put aside the politics of the here and now and focus on more fundamental issues. Those issues include the question of whether the costs of having competing systems of regulation can outweigh whatever benefits may be identified in preserving parallel federal and state coverage. But they should also — and this is a point to which I will return at the end of the paper — include the more general objective of producing simpler and better crafted legislation.

6.1 Framing the Constitution

To understand where that parallel coverage originated, we must go back to the constitutional debates of the 1890s. It was only at the very last Constitutional Convention in 1898 that Charles Cameron Kingston of South Australia secured support for his proposal to confer on the Federal Parliament an express power to legislate on labour matters. Even then the final votes in favour of Kingston's amendment to the draft Constitution were delivered, ironically enough, by a Western Australian delegation who at that stage had real doubts about their own colony joining the federation.

The provision that was inserted into the Constitution, section 51(35), was quite deliberately limited in its scope. It authorised the Australian Government to make laws with respect to 'conciliation and arbitration for the prevention and settlement of industrial disputes extending beyond the limits of any one State'. The wording reflected two preoccupations of the day. The first, and indeed the principal

motivation for having a federal power at all, was an awareness of the possibility of disputes occurring on a scale that crossed State boundaries and which accordingly each State might struggle on its own to control. The delegates to the Conventions still had fresh memories of the industrial conflict that in the early-1890s had spread across eastern Australia in the mining, maritime and pastoral industries, as employers sought to react to the recession of the time by clawing back many of the gains in wages and conditions won by the nascent union movement. The very point of section 51(35) was to allow the Australian Government to establish a process that could meet the challenge posed by such conflict — and therein lay the second preoccupation.

The chosen process was to involve a third party having the authority to step in and seek to resolve industrial disputes, first by bringing the parties together to assist them in reaching a negotiated settlement (conciliation), and then if necessary by hearing their claims and deciding between them (arbitration). Kingston and other colonial leaders of the day, including William Pember Reeves in New Zealand, had already championed the use of this method of dispute resolution within their own jurisdictions. By the time of federation a number of the colonies had made provision for either voluntary or compulsory conciliation and arbitration, and indeed within a few years each of the (now) States had embraced the concept of having a standing tribunal to deal with disputes and regulate working conditions.

It is possible that had the terms 'conciliation and arbitration' not been written into the Constitution, this form of regulation might at some stage have withered away. Other countries had experimented with the idea in the nineteenth century but not pursued it. It took much firmer hold in New Zealand, but even there the concept was gradually abandoned during the 1970s and 1980s, before being finally killed off by the *Employment Contracts Act* in 1991. New Zealand, of course, has a unicameral parliament with plenary or unfettered powers to make laws. By contrast, not only is the Australian Parliament bicameral, but in our federal system it can only make laws on matters specifically enumerated in the Constitution, with the States having the residual power to legislate on matters that either fall outside federal authority, or on which the Australian Government has not chosen to make laws. In the case of industrial conflict, the framers of the Constitution had quite carefully limited the Australian Government to dealing with interstate disputes, and then only through a mechanism that involved conciliation and arbitration.

Aside from section 51(35), there was no other legislative power that explicitly bore upon the regulation of employment or industrial relations in the private sector. In particular, no general power was granted to the Australian Government to fix wages or to stipulate minimum conditions on matters such as working hours, leave, workplace safety, pensions or the like. Education and training were effectively left

to the States, as was the emerging issue of compensation for work-related injuries. Indeed of the various areas of regulation that can today be seen to bear upon the labour market, only the control of immigration and the capacity to fix taxes were obviously allocated to the Australian Government, and even then the latter power was to be shared with the States, who would retain the ability to raise their own revenue. The Australian Government eventually obtained a broad (if not comprehensive) power to establish social security entitlements, including for persons temporarily or permanently unable to find paid work, but only as a result of the amendment of the Constitution in 1946 to include section 51(23A) to supplement the original power in section 51(23) over invalid and old age pensions.

As we will see, the Federal Parliament does in fact have a range of other legislative powers on which it can call if it wishes to regulate employment conditions. Many of these powers are effectively confined to specific types of employer (for example, corporations), or to workers in particular sectors or localities (for example, the Australian Public Service or the Territories), though the taxation and external affairs powers in particular offer the possibility of more general laws. At all events, the use of most of these powers would simply not have been envisaged at the time of federation, with the obvious exception of laws relating to the Australian Government's own workforce. The clear assumption of most delegates to the Conventions was that the States would have primary responsibility for employment and industrial regulation.

6.2 The evolution of federal regulation

That matters did not turn out as originally planned can be attributed to three broad factors: the expansion of the scope of the federal arbitration system through the mechanism of the 'paper dispute'; the growing dominance of the Australian Government over economic and financial affairs; and, though not till much later, successful attempts by the Australian Government to push the boundaries of other federal legislative powers besides section 51(35).

Expansion of the federal arbitration system

Section 51(35) was first used in 1904 to create a Court of Conciliation and Arbitration with powers to prevent and settle interstate industrial disputes either by making awards or by registering agreements. In its early years the Court had little work to do. But that changed as unions, seeing the value of having common conditions across an industry or sector, began to deliberately manufacture disputes with as many employers as possible, rather than waiting for disputes to occur spontaneously. The method of doing so was simple. A union would draw up a list of

demands or ‘log of claims’ and serve it upon as many employers as it could find who operated in the relevant industry or, more commonly, who employed workers in the relevant occupation. The demands would be of outrageous scope (‘ambit claims’) so as to ensure they were rejected, and the union would also be careful to serve employers in more than one State at a time. The dispute that resulted from the rejection of these claims would then be notified to the Court of Conciliation and Arbitration as an interstate dispute. From 1913 onwards, the High Court was prepared to treat these ‘paper disputes’ as properly falling within the Court’s jurisdiction.

Even then, the Arbitration Court might have insisted on resolving such disputes by brokering or if necessary arbitrating a separate resolution for each enterprise. But the early judges of the Court, notably its second President, Justice Henry Bournes Higgins, took the view that it was in the public interest for minimum conditions to be standardised across industries or occupations, and indeed set at a ‘fair and reasonable’ level. Hence they were prepared to resolve these disputes by making awards that applied to each employer that had been a respondent to the dispute. Unlike its state counterparts, the Court could not simply prescribe a ‘common rule’ award that applied to everyone employing the relevant type of labour, since each employer bound must have been involved in or had some connection to the original dispute. But as long as the union was aware of a relevant employer, it could be included (or ‘roped-in’) to a dispute before the Court and thus made a respondent to the award. Periodically, the union would seek a variation to the award, either to increase wages or make some other improvement to prescribed conditions. It would do so either by reopening a previous dispute or by creating a new one.

As this tactic became entrenched, more and more unions sought federal award coverage for their members. Importantly, however, not every union did this. Many were happy to continue to ‘operate’ within the state systems and did not bother to seek a federal instrument. In the case of some workers (such as schoolteachers), any possibility of federal coverage was denied for many years through the High Court’s requirement that only disputes that occurred in an ‘industry’ could come before the federal tribunal. Thus the state tribunals continued to make and vary their own awards, though the practice developed of deferring to the federal tribunal on major decisions such as annual wage increases or the recognition of new entitlements. And of course if a federal and state award both purported to apply to the same employment relationship, the federal instrument would prevail to the extent of any inconsistency, by virtue of section 109 of the Constitution. Nevertheless by 1990, the last time award coverage was formally measured by the ABS, there were still more workers covered by state than federal awards (ABS 1991).

There was no rhyme or reason to the pattern of coverage that ensued from the period of development in the first part of the twentieth century, and there is none today in those States that still have their own arbitration systems. Some employers are governed only by federal awards, others by state instruments. In the case of many larger employers, it is not uncommon for a mixture to apply: according to the Australian Workplace Industrial Relations Survey in 1995, one in five workplaces with more than 20 employees reported dual coverage (Peetz 2005, p. 104). Nor is it easy to predict what type of employer will fall into each system. Employers such as local councils, who are funded by the States, can be and are subject to federal awards. By the same token, large companies that operate across the country must often cope with the application of a number of different state awards, especially for instance where their clerical staff are concerned.

Importantly too, the fact that the States (unlike the Australian Government) had a general power to make laws meant that they could establish minimum standards on matters that either were not, or might not be, covered by federal awards. The most important of these areas in practice were those of occupational health and safety standards and the compensation of injured workers, but it was also common for employers to be subject to State laws on matters such as holidays and long service leave.

The nature of the division of coverage has always presented a certain amount of opportunities for forum shopping, but not perhaps as much as might be supposed. A union (or more rarely an employer) might seek a federal award to regulate work previously subject to a state instrument, but for most of the twentieth century, at least after the initial period of expansion, the federal tribunal's practice was to defer to established State coverage. While this changed during the 1980s and in particular the first half of the 1990s, when the Keating Government legislated to make it easier for unions to escape 'hostile' State systems in Victoria and Western Australia, the Howard Government reinstated and if anything strengthened the previous approach (Creighton and Stewart 2005, pp. 162–5). On the other hand, once federal award coverage was in place it was difficult to revert to a state instrument, since the federal award would inevitably prevail. If an employer was bound by a federal award only because of its membership of an employer association, it might simply resign from that body. But if it was actually named as a respondent it would continue to be bound — and so would any of its successors in business.

Where scope has emerged for a degree of choice more recently has been in relation to agreement-making. Under the formalised systems of enterprise-level bargaining that have been established since the early-1990s in each jurisdiction, it is generally possible for an employer to enter into an individual or collective agreement under the federal *Workplace Relations Act*, even where that agreement will regulate the

employment conditions of workers covered by one or more state awards. Likewise, though this has been less common in practice, employment relationships covered by federal awards may in some instances be the subject of state-registered agreements.

Beyond that, there are situations in which parties may be able to exercise some choice as to whether they pursue a grievance before a federal or state tribunal, regardless of the type of instrument that covers them. This has been especially true of workers pursuing claims in relation to dismissal or discriminatory treatment, but also with employers seeking to restrain workers from taking industrial action.

Financial powers and economic policy

The second factor that has underlain the expansion in federal regulation has been the increasing degree of control exerted by the Australian Government in relation to financial matters and, more generally, economic policy. Since winning its constitutional battle with the States over the uniform tax scheme in the 1940s and 1950s, the Australian Government has had the capacity to influence or indeed direct the regulation of matters over which it does not have any express legislative authority. It does this on the basis that it can raise more revenue than it needs and then make grants that are conditional on Australian Government policies being observed. Vocational education and training has provided a prime example in recent years. Although it is the States that have legislative responsibility over both the TAFE sector and training contracts, the Australian Government has increasingly used its control of the purse strings to direct the structure and regulation of training arrangements, through conditions attached both to the funding of the States and the training subsidies paid to employers. Indeed this is just one of the areas in which the Howard Government is now seeking to use its financial muscle to impose its preferred view of labour market arrangements, as is evident from the 'workplace relations requirements' now being imposed on universities and on any construction companies that wish to tender for federally-funded projects (Howe 2005).

But even going back before the more aggressive use of funding conditions in recent times, we can find instances of the Australian Government seeking to influence labour market outcomes in the name of macroeconomic policy, even where it might not have been able to legislate for those outcomes. The most obvious example has been the Australian Government's role in national wage cases. While this has waxed and waned over the years, and there have occasionally been times when its submissions have been rebuffed, the Australian Government has more often than not been able to get its way. This was particularly the case with the Hawke and Keating Governments during the Accord years. While the Howard Government has been publicly unhappy with the safety net wage decisions handed down by the Australian Industrial Relations Commission (AIRC) in recent years, this perhaps

has as much to do with the Government's discontent with the legislative framework itself, a framework which the AIRC has assiduously sought to apply (Giudice 2005).

Use of 'alternative' powers

The third aspect of the Australian Government's expanding role in labour regulation has been its capacity to call upon legislative powers other than the arbitration power in section 51(35). Over the course of the first century of federation, most Federal Governments have sought in one way or another to find novel uses for powers that might at first glance have seemed to be intended for a different purpose. While the High Court has by no means always been willing to uphold these ambitions, it has aided the progressive centralisation of legislative authority in four key ways.

In the first place, the Court has by and large refused to take an 'originalist' approach to constitutional interpretation. Rather than always deferring to the actual or presumed purpose of those who drafted the document, the Court has generally been willing to treat the Constitution as a 'living' instrument whose terms must be interpreted by reference of the context and concerns of the present day, not 1900.

Secondly, since the Engineers decision in 1920[1] the Court has rejected the notion that certain powers are to be taken as 'reserved' for the States. Provided a federal law does not threaten the federal nature of the Constitution by discriminating against or between the States, or by unduly impinging on their capacity to operate autonomously, it is sufficient for that law to be valid that it can be characterised as dealing with a subject that falls within the bounds of one of the Australian Government's enumerated powers.

Thirdly, the Court has taken a liberal approach to that process of characterisation. So long as a law deals with a subject that is within one of the heads of power, it does not matter that it can also be characterised as being about a subject that falls outside those heads, nor indeed that the principal concern of the legislators may have been to regulate that latter subject. Take for instance the superannuation guarantee legislation. There is no doubt whatever that the main purpose of that legislation is to require employers to contribute to their employees' superannuation funds. Nowhere in the Constitution does it say that the Australian Government may legislate on superannuation. On the other hand, section 51(2) lists 'taxation' as a permissible subject for legislation, and the superannuation guarantee scheme actually operates by imposing a tax on every employer who fails to make the minimum contributions. Although the validity of the legislation is yet to be tested, a

1 *Amalgamated Society of Engineers v Adelaide Steamship Co Ltd* (1920) 28 CLR 129.

similar scheme (now abolished) that required employers to spend a minimum percentage of their payroll costs on training was upheld by the High Court in 1993. The fact that the Australian Government had no intention of raising any revenue did not prevent the Court from characterising the training levy as a law about taxation.[2]

The same point is evident in the High Court's interpretation of what has perhaps become the most politically contentious of all the Australian Government's legislative powers, that over 'external affairs' in section 51(29). It is now clear that the Australian Government, subject to any other constitutional limitations, can use this power to legislate on any matter of international concern. It may in particular give effect to treaty obligations, regardless of whether the subject is otherwise within its defined powers. This explains, for instance, how the Australian Government has been able to enact legislation dealing with various forms of employment discrimination.

Fourthly, and with only a few exceptions, the Court has refused to interpret the various heads of power by reference to any concept of 'mutual exclusiveness'. The fact that one head of power may be used in such a way as to go beyond the limits of another power does not mean that the first power will be construed narrowly so as to prevent any overlap. In World War II, for instance, the Australian Government used the defence power in section 51(6) to control employment conditions throughout the country. This was found to be valid by the High Court, notwithstanding that the scope of the regulation ignored the limitations inherent in the arbitration power.[3]

What all this means is that the Australian Government is by no means confined to regulating employment and industrial matters in the manner suggested by the constricted terms of section 51(35). If it wishes to prescribe employment conditions directly, or regulate industrial relations in a way that does not involve conciliation or arbitration, or concern itself with issues that arise within a single State, it may do so — provided the law in question has an appropriate link to a subject that falls within one of its other heads of power.

As it happens, the use of such alternative powers has not (at least until now) resulted in any radical recasting of federal and state responsibilities for labour regulation. It is true that since the 1970s, and more especially over the past 15 years, the Australian Government has used some of its powers to legislate in ways that would not at all be possible under the arbitration power. Besides the examples already given of the superannuation and training levies, and of the anti-discrimination legislation, we may note the Keating Government's use of the

2 *Northern Suburbs General Cemetery Reserve Trust v Commonwealth* (1993) 176 CLR 555.

3 *Pidoto v Victoria* (1943) 68 CLR 87.

external affairs power in 1993 to establish a universal entitlement to unpaid parental leave, and also a right to complain of unfair or unlawful termination of employment. In most of these cases, however, the laws in question were framed so as not to operate to the exclusion of state laws granting similar entitlements or protection.

In other cases, and indeed more commonly, alternative powers have been used to expand the reach of the federal arbitration system without essentially altering its character. The main powers used in this regard have been those over interstate or international trade and commerce (section 51(1)), trading, financial or foreign corporations (section 51(20)), the public service (section 52(2)) and the Territories (section 122). Also important in recent years has been the power under section 51(37) to legislate on any matter referred by a State Parliament, since the Kennett Government's decision in 1996 to hand over most of Victoria's powers over labour regulation in that State.[4]

If we go through the current *Workplace Relations Act* we can find any number of examples of what may be termed supplemental use of such powers. For example, the AIRC may take jurisdiction over any industrial dispute that involves maritime or waterside workers, even if there is no interstate dimension. It may also make a common rule award that has effect in Victoria or the Territories, where this would not be permitted under the arbitration power. Similarly, an agreement regulating employment conditions may be registered by any employer that is a trading, financial or foreign corporation, or an Australian Government agency, even though the agreement may not be seen to have prevented or settled an interstate dispute.

Nonetheless, while none of these extensions may in themselves have revolutionised the operation of the federal arbitration system, they have contributed to its gradual expansion. Importantly too, their use over the past 15 years has coincided with other reforms whose thrust has been away from the very concepts that underpinned the traditional arbitration system: those of third-party involvement and of standardisation of conditions.

6.3 Labour market reform and the (partial) transformation of labour regulation

If we go back to the mid-1980s, we find a system of industrial regulation that had operated for many years in a fairly stable and predictable fashion. Around 85 per cent of workers had their minimum wages and certain other conditions set by awards, mostly either state awards that operated on a common rule basis, or multi-

[4] See *Commonwealth Powers (Industrial Relations) Act 1996* (Vic); *Workplace Relations and Other Legislation Amendment Act (No 2) 1996* (Cth); Kollmorgen (1997).

respondent federal awards. Within this award sector, there were many local collective agreements that dealt with enterprise-specific issues, but these were generally informal. Many employees also received over-award payments, whether by individual or collective agreement. Most of those outside the award sector were managerial or professional employees, whose conditions were set almost exclusively by individual contract. There was relatively little detailed regulation of employment conditions by statute, other than in the public sector and, more generally, on the issue of workplace safety. Around 45 per cent of the workforce was unionised, a figure bolstered by the prevalence in some sectors of 'closed shop' arrangements that made union membership compulsory. Industrial action was frequent (though already beginning to lessen), generally short-lived, but invariably unlawful.

Fast-forward to 2005 and the picture has changed quite dramatically. The proportion of workers covered by awards has fallen, probably to around 70 per cent or so, though without reliable statistics it is hard to be sure of the precise figure. With the handover of power in Victoria, more workers are now covered by federal than state awards. More importantly, over 40 per cent of the workforce is now covered by registered workplace agreements that prevail over awards and that generally provide for periodic wage rises. Some of these agreements are individual Australian Workplace Agreements (AWAs) that are registered under the *Workplace Relations Act*, though they appear to cover no more than 4 per cent (if that) of all workers. There are also many non-union collective agreements, but by far the majority of workers in this category are covered by agreements with unions, even though less than a quarter of the workforce is now unionised (and less than a fifth in the private sector). There is now a limited right to take industrial action in seeking to negotiate such agreements, at least in the federal and some state jurisdictions. Award-covered workers who do not have agreements, especially in smaller businesses and community organisations, must rely on 'safety net' award adjustments to obtain wage increases, unless their employers are willing to make over-award payments. Direct statutory regulation of employment conditions has increased for the workforce as a whole (including the non-award sector), except that in the public sector conditions are increasingly negotiated rather than being set by legislation.

How did these changes come about? The story initially was one of reforms occurring within the arbitration systems, not to those systems.[5] In the late-1980s and early-1990s a tripartite alliance of the Hawke Government, the ACTU and

[5] One exception to this pattern was the introduction in Queensland in 1987 of a system of 'voluntary employment agreements', under Part VIA of the *Industrial Conciliation and Arbitration Act 1961* — see Hall (1988). In practice though these had little impact before their repeal in 1990.

major employer groups led a push for changes to wage fixation and award regulation. Initially concerned to restructure awards so as to remove outdated work practices and encourage multi-skilling of workers, especially in manufacturing, the reform agenda gradually broadened to make 'productivity bargaining' at the level of each enterprise a prerequisite to gaining wage increases. The reasons for pursuing this course were many and varied, and not always shared by the key stakeholders, but a common theme in the public rhetoric of the time was (and has remained) an emphasis on the need to improve productivity so as to meet the challenges posed by an increasingly globalised economy.

At the federal level, the new emphasis on enterprise-level bargaining was ultimately reflected in legislative amendments in 1992 and 1993.[6] These recast the 'objects' or stated purposes of the legislation so as to place a primary emphasis on workplace-level negotiation. Parties were encouraged to formalise their agreements and register them with the AIRC. Crucially, the AIRC's power to determine whether such agreements were in the public interest was removed. Henceforth, if an agreement met the statutory criteria it must be registered, whether the AIRC liked it or not. While award regulation was retained, awards were now to assume a secondary role as a 'safety net', applying only to workers who had not negotiated an agreement, though also setting a benchmark for bargaining through the 'no-disadvantage test' (NDT). Under that test, no agreement should be registered if it left workers any worse off on balance than they would have been under the relevant award.

In 1996, the Howard Government strengthened the emphasis on agreement making still further and introduced the option of individual AWAs, to go along with collective certified agreements.[7] Importantly, the need to secure the support of the Democrats in the Senate frustrated the Government's bid to remove the NDT. It did though succeed in reducing the circumstances in which the AIRC was permitted to arbitrate disputes, and it also narrowed the scope of awards by confining them to certain 'allowable' matters. Despite these changes, the AIRC has continued to play a significant role in assisting parties with the resolution of disputes, both during bargaining rounds and in relation to the application or interpretation of agreements (Stewart 2004).

Similar reforms occurred in each State during the 1990s, though mostly under conservative rather than Labor governments (see Nolan 1998). In Queensland, each major federal initiative was followed by a state measure that copied it almost word-

6 *Industrial Relations Legislation Amendment Act 1992* (Cth); *Industrial Relations Reform Act 1993* (Cth).

7 *Workplace Relations and Other Legislation Amendment Act 1996* (Cth). This amended the *Industrial Relations Act 1988* and also renamed it the *Workplace Relations Act 1996*.

for-word.[8] But in two States the changes went much further. In 1992 the Kennett Government's *Employment Relations Act 1992* effectively abolished state awards and swept away almost every vestige of compulsory arbitration, in favour of a system of individual employment agreements. However the take-up rate for these agreements was never substantial: most businesses seemed content to operate simply according to the default standards enshrined in the legislation, which included a frozen version of the previous award conditions. And in any event many unions, with the assistance of the Keating Government, endeavoured to shift to federal award coverage. With the passage of the federal reforms in 1996, the Victorian Government decided to dispense with the time and expense of having a state system and arranged for a referral of powers to the Australian Government.

The other State which pursued a more radical agenda in the 1990s was Western Australia, under the Court Government.[9] While retaining an award system and provision for collective agreements, a parallel system of individual workplace agreements was created. Parties could enter into these with a minimum of fuss and they needed only to comply with certain basic statutory conditions. The take-up rate of these agreements was never substantial, covering perhaps no more than 7 per cent of the WA workforce at their peak, but their impact in certain sectors (notably the mining industry) was significant. With the reform of the individual agreement system in 2002,[10] many employers who had previously used such agreements have now switched to AWAs instead. The fairly modest degree of 're-regulation' under Labor in WA has also occurred in most other States as well, though in no jurisdiction has there been a serious attempt to restore award regulation to any form of primacy. If anything, the emphasis has been on extending the number of employment conditions that are prescribed as statutory minima.

Today, therefore, each jurisdiction effectively has a 'hybrid' regime, which on the one hand seeks to encourage workplace bargaining as the primary method of determining employment conditions, yet also retains many elements of the old arbitration systems. Even within workplaces covered by agreements, it is still common (at least where unions are involved) for disputes to be taken to the industrial tribunals for resolution. And at least 20 per cent of workers are still engaged under award conditions alone, especially in industries such as retail, hospitality and community services.

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8 Even down to the title: see *Industrial Relations Reform Act 1994*; *Workplace Relations Act 1997*. The pattern was broken by the *Industrial Relations Act 1999*, which was influenced instead by the *Industrial Relations Act 1996* in New South Wales.

9 See *Industrial Relations Amendment Act 1993*; *Workplace Agreements Act 1993*; *Minimum Conditions of Employment Act 1993*.

10 See *Labour Relations Reform Act 2002*.

One final point to make about these regimes concerns their increasing complexity. There are at least two different dimensions to this. The first concerns the number of different regulatory instruments that may now apply at any given workplace (Bray and Waring 2005; Fetter and Mitchell 2004). Going back 20 or 30 years, a typical employer had to worry about little more than a few awards (which could admittedly be lengthy and detailed), perhaps a local agreement (which was rarely enforced in any strict legal sense) and a handful of statutes, while a few senior employees might have written contracts. Today that list of instruments is greatly expanded. While awards may be shorter and somewhat simpler than they used to be (though this is not always true in relation to key issues such as working hours and penalty rates), there are far more statutory provisions than there used to be, it is more likely that employees will be engaged under some form of written contract, and formal management policies and procedures (which may or may not have contractual effect) have also multiplied. Where a registered agreement is in place, it rarely excludes the operation of a relevant award entirely; and even if it does, the employer must still usually be concerned about that award as it may influence the content of the agreement through the operation of the NDT. In some instances too, as we have seen, the employer may effectively have to comply with some form of government regulation which, although not directly binding, is made a condition of securing public funding.

The second source of increased complexity in regulation has been the vast growth in the quantity and detail of legislation, especially at the federal level. While this has been a general problem in Australia, and indeed across the world (Argy and Johnson 2003), it has been especially notable in the context of industrial legislation. Through a combination of inelegant drafting, excessive and unnecessary concern for constitutional validity, and a lack of trust in regulatory institutions, the main federal statute has blown out to become bloated, convoluted and in parts almost unintelligible (Stewart 2005).

The principal problem has been a shift in legislative approach that occurred under the Keating Government, and that has been taken to even greater extremes under the Howard Government. The traditional approach — and it can still be seen, though to a diminishing degree, in some state statutes — was to express obligations, powers or processes in broad general language and then leave it to agencies or adjudicators to implement and interpret those provisions in light of the stated objects of the legislation. But since 1992 federal legislation has been drafted so as to attempt to deal with every contingency and to regulate in the minutest detail every possible decision-making process. The problem with this, as every lawyer knows, is that the more Parliament tries to anticipate every eventuality, the more doubt and uncertainty is created. As one loophole is closed or ambiguity resolved, another opens up. The result is that the costs for both businesses and unions who have to

operate within this regulatory regime have spiralled, due to the need to consult lawyers at every turn.

Now the Australian Government would no doubt argue that any additional transaction costs associated with operating under the *Workplace Relations Act* are outweighed by the benefits to businesses, workers and the wider community that are said to have resulted from the reforms of the past decade, especially in terms of higher productivity and consequently economic growth and rising employment. Whatever the merit of those claims, however, it is not apparent that the Government has at any stage stopped to consider whether it might be possible to deliver the same outcomes through regulation that is simpler and more intelligible. Indeed the changes recently passed by Parliament will result in an even larger and more unwieldy legislative framework. I will return to that point later, but for the moment it is time to look at those changes and in particular what they mean for the 'federal balance' in this area.

6.4 The Howard Government's reforms

After being forced to compromise in 1996 to secure the passage of its legislation, the Howard Government repeatedly proposed further changes to the *Workplace Relations Act*. Most of these were rejected or heavily modified by the Senate.[11] Since gaining control of the upper house in mid-2005, however, it has been able not merely to clear this backlog of amendments, but to pursue more far-reaching reforms.

Some groups have pressed the Government to take advantage of the Senate majority to radically restructure the existing system of regulation (see, for example, ACCI 2005). However the package of changes recently implemented by the Government continues down the path of incremental reform commenced in 1992-1993 and carried on in 1996. While the implications or consequences of some of the changes are profound, even 'revolutionary', the resulting system will for the time being, it appears, retain the 'hybrid' characteristics to which reference has already been made.

The changes are embodied in the *Workplace Relations Amendment (Work Choices) Act 2005*, which amends and indeed substantially rewrites the 1996 Act. At the time of writing it was expected that most of the amendments would take effect as from March 2006. The major features of the Work Choices legislation include:

11 See, for example, *Workplace Relations Legislation Amendment (More Jobs, Better Pay) Bill 1999* (Cth).

- removing the NDT, so that a broader range of award and statutory entitlements may be bargained away, and making agreements much simpler to register — in other words, moving to a system very much akin to the previous regime in WA, in which the only 'safety net' for bargaining is set by a short list of minimum legislative standards;
- retaining awards, but reducing their scope still further;
- retaining the AIRC, but stripping it of key functions such as wage-fixing and approval of agreements;
- introducing a Fair Pay Commission to determine award wage increases (doubtless at a lower and/or slower rate than the AIRC), as well as expanding the role of the Office of the Employment Advocate;
- forcing unions to hold secret ballots as a precursor to taking protected industrial action, and making it much easier for businesses to get such action stopped; and
- exempting any firm that employs 100 or fewer workers from unfair dismissal claims.

Beyond that, and as already mentioned, the Government has indicated its desire to create a 'national' or 'unitary' system of regulation, preferably by cooperation from the States, but if necessary by using the corporations power in section 51(20) of the Constitution. Indeed it is now clear that, other than in relation to certain transitional arrangements discussed below, the amended *Workplace Relations Act* will no longer be based on the arbitration power at all, but essentially just on the corporations power, backed up by the public service power, the Territories power and (in relation to Victoria) the reference power. This combination of powers will enable the revamped Act to apply to all Australian Government agencies, all employers in the Territories, all employers in Victoria (with the partial exception of the State of Victoria itself), and in the other States all trading, financial and foreign corporations.

The idea of basing federal regulation on the corporations power was originally aired by then Minister for Workplace Relations Peter Reith in 1999 and subsequently developed in a series of discussion papers (Reith 2000b, 2000c, 2000d; and, for comment, see Stewart 2001). Instead of the complex and technical processes demanded by section 51(35), notably the artificial creation of interstate disputes so as to confer jurisdiction on the AIRC, it was claimed that 'a coherent national framework of minimum standards' could be established for the conduct of workplace relations in corporations (Reith 1999, p. 2). By relying on the corporations power alone, it would be possible to break what was described as the 'gridlock of technicality' associated with the present federal system.

The potential reach of the corporations power is of course determined by the number of employers who have that status. In practice, the majority are incorporated; but there are many small or even medium-size businesses that involve sole traders, or operate as partnerships or through family trusts, rather than companies. This is especially true in the farming sector, where few businesses are incorporated. There are also charitable bodies and other service-providers that, although incorporated, might not be regarded as trading corporations for the purposes of section 51(20). Then we have State government agencies. While there are certainly many such agencies that would be regarded as trading or financial corporations, including councils and educational institutions, State government departments would plainly fall outside the reach of the power. There are in any event limits to the Australian Government's capacity under the Constitution to regulate State public sector employment (Creighton and Stewart 2005, pp. 113–116).

Since 2000, the Australian Government has repeatedly claimed that a 'corporations-based system' would cover 85 per cent of the workforce (see, for example, Australian Government 2005, p. 11). But that assumes use of the other powers listed above to extend coverage in Victoria, the Territories and the federal public sector. Outside Victoria, the figure in each of the other States would undoubtedly be less than 85 per cent. Indeed the Queensland Government, which unlike the Australian Government has been prepared to disclose the data on which it is relying, has claimed that the new federal system would cover at most 75 per cent nationally, and less than 60 per cent in States such as Queensland, South Australia and Western Australia (QDIR 2005). For those States, this would suggest they would be left with far more than the 'rump' that has sometimes been mentioned in this context.

Nonetheless, it is clear that by relying on the corporations, public service, Territories and reference powers in combination, the Australian Government can extend the reach of its system beyond the coverage produced by the arbitration power — which as noted earlier has principally depended on the willingness and ability of unions to generate interstate disputes and bring them before the federal tribunal. There would be some loss of coverage, as unincorporated employers outside Victoria and the Territories who were covered by existing federal awards or agreements 'dropped out' of a corporations-based system. On the Government's own estimate in 2000, there would be over 100 000 employees working for such businesses (Reith 2000b). To deal with this sector, the *Work Choices Act* provides that the employers concerned will have five years in which either to incorporate (and hence stay in the federal system), enter into a State agreement or otherwise apply to the AIRC to be 'released' from federal coverage. If they do none of those things, they will remain subject to their existing instruments until the expiry of the

five-year period, at which point they will automatically 'fall back' into the relevant State system.

What then of corporate employers who might otherwise prefer to remain bound by state instruments? The answer is that they will not be given that choice. State agreements made by corporations will be deemed to have the force of federal law. State awards that are applicable to them will likewise be deemed to operate as 'notional' federal agreements, though for no more than three years. By the end of that period, such businesses will be expected to have shifted to federal agreements, or may alternatively become subject to federal awards. The intention then is to create some kind of exhaustive federal 'code' for corporate employers to which, like it or not, they will be subject. At the very least, they will be 'immunised' from the impact of state awards.

In principle the Australian Government could seek to extend that strategy to cover all types of state legislation, so that a corporate employer need only be concerned about meeting obligations under federal law. However while employers and employees covered by the new federal system will not as a general rule be subject to regulation by other 'industrial' or 'employment' laws, the new legislation preserves the operation of State and Territory statutes on matters such as occupational health and safety (OHS), workers' compensation, discrimination, training, public holidays and long service leave. The exclusion of the first two categories does not come as a surprise. Although the Prime Minister's statement of 26 May 2005 spoke of implementing 'national standards' in relation to OHS, and of pursuing a 'national approach' to workers' compensation (Howard 2005c), there has been no subsequent mention of enacting 'corporations only' OHS or workers' compensation laws. For the time being too, it remains unclear whether the Government will seek to move beyond employment-related laws and exclude state regulation that has more general application to 'commercial' arrangements — including for instance the new Victorian legislation on owner-drivers and forestry contractors.[12]

At the very least though, the Australian Government is endeavouring to remove companies from the reach of the mainstream state industrial laws on employment conditions and industrial grievances. This raises the question of whether this can be done under the Constitution at all, and to that we now turn.

12 See *Owner Drivers and Forestry Contractors Act 2005* (Vic); and see also *Industrial Relations Act 1996* (NSW) Ch 6. Cf the proposals canvassed in DEWR (2005), pp. 15–20.

6.5 What will the Constitution allow?

It seems likely that during 2006 the State Governments and/or trade unions will mount a constitutional challenge in the High Court to the Work Choices legislation. But while there may be sound strategic or political reasons for taking this step, a challenge seems unlikely to succeed, at least in relation to the central issue of basing employment regulation on the corporations power (Ford 2005; Gray 2005).

As George Williams (2005) has pointed out, the High Court has not yet arrived at a definitive view as to the scope of the corporations power. Nevertheless in 1996, when ruling on the validity of the Keating Government's 1993 reforms, the Court did not even question the idea that the power may be used to regulate agreement-making between a corporation and its employees.[13] A year earlier, in the Dingjan case, a majority of the Court took the view that section 51(20) was wide enough to support laws regulating the 'activities, functions, relationships or business' of a corporation.[14] On that basis, it is hard to argue with Justice Gaudron's observation in 2000 that the power would 'extend to laws prescribing the industrial rights and obligations of corporations and their employees and the means by which they are to conduct their industrial relations'.[15] In the same case, Chief Justice Gleeson noted that the scope of the corporations power would not be affected by any limitation on the Australian Government's capacity to regulate employment conditions under the arbitration power.[16] In other words, just because the arbitration power does not authorise laws directly establishing minimum conditions or dealing with intrastate disputes does not mean that the corporations power must be similarly confined.

Against the background of these previous pronouncements, it would be surprising, not to say radical, for the High Court now to adopt a much narrower view of the corporations power, for example by insisting that a trading corporation may only be regulated in relation to its 'trading' or commercial activities. It would certainly then seem possible for the Australian Government to use the power to set minimum conditions for employees of corporations, to allow the making of agreements between corporations and their workers, and to regulate the conduct of unions representing such workers. The same logic would also suggest that the Australian Government may 'protect' corporations from the operation of State laws that might otherwise impinge in these areas.[17]

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13 *Victoria v Commonwealth* (1996) 187 CLR 416.

14 *Re Dingjan; Ex parte Wagner* (1995) 183 CLR 323.

15 *Re Pacific Coal Pty Ltd; Ex parte CFMEU* (2000) 203 CLR 346 at 375.

16 *Re Pacific Coal Pty Ltd; Ex parte CFMEU* (2000) 203 CLR 346 at 360.

17 As to the capacity of the Australian Government to prevent the operation of State laws, see Lindell (2005). There may be some doubt as to whether the Australian Government can legislate

Importantly, and to repeat an earlier point, once the Australian Government decides to draw on the corporations power, or for that matter any of the 'alternative' powers, there is no constitutional need to retain an emphasis on dispute resolution by an independent tribunal, or an award system, or provision for collective bargaining, or indeed any role for trade unions. Of course political reasons may dictate their retention, at least for a time. When the Australian Government originally canvassed the possibility of using the corporations power it was at some pains to downplay the possibilities for more radical change and insist that the 'fundamentals of the system' would be retained (Reith 2000c, p. 17); and as we have seen, the Work Choices reforms will preserve (albeit with diminishing significance) each of those elements. But in the longer term it seems reasonable to suppose that the Australian Government, and many of their supporters, would prefer a system of individual agreements backed by a small number of legislated minimum standards, with no formal role for either unions or tribunals.

The very fact that the corporations power has none of the 'traditional' connotations of the arbitration power, and could as easily support an *Employment Contracts Act* (see, for example, Moore 2005) as an *Industrial Relations Act*, is doubtless one of the reasons why the labour movement is so distrustful about its use. Ron McCallum has stressed the dehumanising potential of centring laws around corporations rather than the 'flesh and blood persons' who deal with them. Labour laws, he argues, are unlikely to retain a 'wholesome' balance between employers and employees 'as equal legal actors in the processes of work and production'. Ultimately, he suggests, such laws are likely to become 'little more than a sub-set of corporations law because inevitably they will fasten upon the economic needs of corporations and their employees will be viewed as but one aspect of the productive process in our globalised economy' (McCallum 2005, p. 469).

Whatever the truth of those observations, if there is a major question mark over the validity (as opposed to morality) of using the corporations power, it is whether it can continue to underpin the extensive regulation of the internal affairs of registered trade unions and employers associations that has become such a feature of the arbitration system over the years. In the interests of space I will not pursue that question in this particular paper, though I have explored it elsewhere (Stewart 2005). It is certainly an issue that has been exercising minds in some of the employer associations in particular (Davis 2005).

to create a regulatory 'vacuum' (ibid, pp. 37–39). But it is surely different if the Australian Government is seeking to prevent State laws from dealing with the rights of employees or unions in relation to corporations, when those are matters covered by otherwise valid federal laws.

In any event, and as we have seen, even the most extensive use of the corporations power must leave gaps, at least outside Victoria, the Territories and the federal public sector. Are there other options under the Constitution for filling those gaps? One possibility would be to use the trade and commerce power to pick up businesses that have some connection to interstate or overseas trade, but since most of these are likely to be incorporated anyway the extension might not be significant. If the High Court could be persuaded to take a more expansive view of the trade and commerce power than it has done in the past, it might even be possible to base an entire system of regulation on that power and reach every form of labour use (see McCann 2004); though the prospects of that happening are not great, and in any event it is unlikely the Australian Government would be prepared to gamble on the Court reversing its current stance.

A more obvious way of extending coverage would be through the external affairs power, given the wide range of issues now covered by international conventions. This would, for example, be the easiest way of creating a national system of workers' compensation or occupational health and safety regulation. However the Howard Government, unlike its predecessor, has repeatedly disclaimed any intention to make any wider use of this power. Issues of political philosophy aside, this view may well be grounded in pragmatism. Australian laws have repeatedly been identified as breaching International Labour Organisation (ILO) standards in a number of areas, especially in relation to the core principles of freedom of association (CEACR 2004, 2005). It might be difficult in practice to justify national legislation as being based on such standards, especially when the ILO's main instruments are oriented to collective bargaining, not individual arrangements.

In theory, at least on its current interpretation, it would be possible to base just about any type of law on the taxation power, so long as the law were framed in terms of imposing a tax as a penalty for failing to do something. But there are obvious political obstacles to any extensive use of this power, and it remains possible that the High Court will pull back from the generous approach it adopted in relation to the training levy.

Essentially then, there is no realistic way of achieving a fully national system without the cooperation of the States. That cooperation might take the form of the States either referring their powers to the Australian Government or enacting their own 'complementary' legislation (though note the problems with the latter option highlighted by Ford 2005, pp. 218–19). But even in the absence of such cooperation, what the Australian Government can probably do is to create a single (or something close to a single) regulatory system for a majority of employers, including by definition just about every large employer other than the States themselves.

6.6 A national system or competitive federalism?

That brings us then to the question of whether there is a persuasive case for such a move towards a national system. There has certainly been a strong and consistent view in business and legal circles to that effect (see, for example, BCA 2000), and many academics have also argued the case (see, for example, Creighton and Stewart 2005, pp. 123–4). There appear to be three main strands to the argument.

The first concerns the inefficiencies and costs created by duplications, overlaps and incoherence of federal and state legislation. At the most basic level, it can be difficult for even experienced practitioners to know which laws apply in certain situations, especially where award coverage is concerned. As the Hancock Committee noted in 1985, following its review of industrial regulation, such a situation 'benefits no one', but 'creates unnecessary difficulties and technicalities in the labour inspection and enforcement process' (Hancock 1985, vol. 2, p. 267) — and also, one might add, in the ordinary process of running a business. The Committee also highlighted the potential for inconsistent results and varying standards between federal and state systems, not to mention forum shopping and demarcation disputes. As the current President of the AIRC has more recently observed:

> The laws are not uniform, the processes differ and the interaction between jurisdictions can be confusing and frustrating. If the law is seen to operate in an inconsistent way depending upon the statutory regime governing the proceedings, that is not a good thing for either party nor is it in the public interest. Confidence in the tribunals, the courts and the law itself is diminished. (Giudice 2002, p. 11)

The second broad argument emphasises the importance of labour market regulation to macroeconomic policy and the need therefore for the Australian Government to be able to exercise appropriate forms of control. As Creighton and Stewart (2005, p. 124) put it, '[t]he relatively small size of the Australian economy, together with its high levels of integration and interdependence, suggest that industrial relations should be a matter of federal responsibility, as is the case in relation to most other fundamental features of economic activity.' It was this argument, perhaps more than any other, that persuaded the Constitutional Commission (1988, pp. 794–803) to recommend that section 51(35) be reworded to give the Australian Government power to legislate with respect to 'industrial relations'. The Commission recognised that views would inevitably differ as to the most appropriate form of regulation, but was firm in believing that it was the Australian Government that should be making the choices.

Thirdly (though it is less common to find this view being expressed, especially by employer groups), there is the perceived danger of the 'race to the bottom'. If employers are in a position to forum shop, there is a concern that jurisdictions may

compete to attract business by lowering labour protections — something that might be regarded as a form of destructive horizontal competition, to borrow terms used by Jonathan Pincus. While this can occur as between the Australian Government and the States (and indeed has happened in the last few years with certain employers fleeing the 're-regulated' individual agreement system in Western Australia and transferring to AWAs), this is more obviously directed to the possibility of States dropping minimum standards in a bid to entice employers to relocate. There was more than a whiff of this during the 1990s in relation to workers' compensation entitlements (Purse 1998), though it has been less obvious in relation to other forms of labour regulation.

In any event there are those who challenge the case for a national system, or at least a national approach on every issue. While accepting that there is room for improvements to the current arrangements, some question whether the problems of overlap and conflict between the jurisdictions are as significant in practice as is often claimed. Even in 1985 the Hancock Committee noted that 'recent developments (both legislative and through the cooperation between tribunals) have led to a reduction of the potential for inconsistencies of outcome and for the application of varying standards' (Hancock 1985, vol. 2, pp. 268–9). The Committee emphasised Australia's 'history of shared powers' and expressed the view that 'entrenched positions, at both the political and industrial levels' were likely to militate against the success of any attempt to move to unitary regulation (Hancock 1985, vol. 2 p. 278). In particular, it rejected the notion of the Australian Government pursuing such a system by relying on powers other than section 51(35):

> We see considerable difficulties in this approach. First, there is some risk of invalidity; secondly, the move would undoubtedly be divisive and strenuously opposed by State government and State-based interests; and thirdly, there would be gaps in coverage … There are other means at the disposal of governments to redress the problems of multiple tribunals which are less divisive and speculative. (Hancock 1985, vol. 2, p. 277)

In the result, the Committee recommended 'evolutionary change' through 'cooperation and discussion between governments and the industrial parties' (Hancock 1985, vol. 2, p. 278). Since then, there have been further moves to coordinate the work of the federal and state tribunals (see Creighton and Stewart 2005, pp. 142–5). While these have not eliminated all instances of interjurisdictional conflict, it is fair to say that the tribunals today are working more closely together than ever before.

Another area in which there has been considerable improvement has been the regulation of industrial associations. There have been times when the dual registration of unions under both federal and state law has caused all kinds of legal

problems, which in turn have been exploited by warring factions within those unions (see Creighton and Stewart 2005, pp. 490–4). But while these problems have been only partially addressed by legislative changes, it is far less common these days for dual registration issues to crop up in intra-union disputes.

Coming back to the position that confronts modern businesses, it has been claimed that there is little hard evidence to suggest that they are struggling with the need to deal with two sets of laws in most States — or indeed in all States, for even in Victoria matters such as long service leave, workers' compensation and OHS are still regulated by State law. David Peetz (2005, p. 104) notes that in 1995 the Australian Workplace Industrial Relations Survey reported no significant difference in productivity improvements at firms with dual award coverage, as compared to firms that had workers covered only by federal or state awards. Ron McCallum (2005, p. 466) has also pointed out that under the current system corporations can use federal agreements to escape state regulation. The fact that many have nevertheless still chosen to operate under State laws 'puts the lie to any urgency in this matter'.

The retention of dual coverage can also be presented as a positive virtue in relation to labour regulation. The Productivity Commission (PC 2005f, pp. 354–5), while backing the case for further 'competition-related' reforms and warning against 'any backsliding that reduced flexibility and the capacity to tailor labour market arrangements to the circumstances of particular firms and the needs of an ageing population', has questioned 'whether national coordination would necessarily represent a step forward'. It quotes a submission from the Western Australian Chamber of Commerce and Industry to the effect that the current system 'allows for diversity and for improvements through the rivalry and demonstration effects that flow from competitive federalism'. Even under an expanded federal system there might still, according to the Commission, be scope for 'beneficial jurisdictional competition', for instance by allowing employers to 'opt in' to a national regime.

Although the Commission did not elaborate on this, such a goal could readily have been achieved by the Howard Government dropping that part of its plans that involves state regulation being overridden. Corporations, in other words, might have been allowed to retain the choice that McCallum notes some of them currently have, to be bound by state awards and/or agreements, and to take their disputes to a state tribunal rather than the AIRC.

The question though is whether the costs that are inevitably associated with retaining two sets of institutions and processes in each State are outweighed by any gains that can be realised from 'rivalry and demonstration effects'. It is certainly possible to identify examples of one jurisdiction 'experimenting' with a form of regulation in a way that inspires others to either follow its lead or learn from its

mistakes. One instance is the spread of the 'individual right' model of unfair dismissal protection that was first embraced in South Australia and then spread to every other jurisdiction during the 1980s and 1990s — only to result in a 'botched' set of federal arrangements that in turn inspired most other jurisdictions to limit or exclude that protection in various ways (Creighton and Stewart 2005, pp. 450–5; Stewart 1995). A further example might be the various agreement-making systems that were introduced in the 1990s. There seems little doubt that the Western Australian version, itself a compromise between the 'no-disadvantage' federal regime and the more radical 1992 reforms in Victoria, has shown the way for the present Australian Government.

On the other hand, it can be argued that there is still a potential for experimentation within a single system. In the days of the 'old' award regime, it was not at all unusual for entitlements to be developed through negotiation and if necessary arbitration in one or more sectors and then spread to other awards, often through a 'test case' decision. More recently, we have seen a similar spread of ideas and provisions through the formalised process of enterprise bargaining, for example in relation to paid maternity leave. Even if there were only a single system of regulation, at least for corporations, we could still expect to see this kind of process.

6.7 Conclusion: crafting 'good' labour market regulation

To return to the point made in the introduction, it will always be hard to find consensus as to what constitutes 'good' or 'effective' labour regulation — and any assessment is bound to be clouded for many by short-term political concerns.

So it is in relation to the question of whether we should have a national system of regulation. It is no coincidence that the calls from business groups for such a system have become more strident at a time when a Coalition Government is in office federally and the States and Territories are controlled by Labor, and have increased in urgency since the Australian Government gained control of the Senate; nor that the main notes of caution from within the business sector have been sounded by State-based employer associations that fear a loss of relevance under a unitary system. Similarly, it should not surprise us that a labour movement that was so supportive of the Keating Government expanding its use of 'alternative' constitutional powers to extend minimum standards and protect workers from 'hostile' State Governments should now be concerned about the Howard Government adopting similar tactics. Back in the 1990s it was conservative State Governments that mounted a constitutional challenge to a 'radical' expansion of

federal jurisdiction;[18] a decade later we have a group of Labor Governments threatening exactly the same step.

Nor has the Howard Government been consistent in its commitment to a national system. In 1996, as previously mentioned, it introduced amendments that were actually designed to make it harder for federal regulation to displace established state coverage, at a time when it felt that some of those state regimes should be politically supported. Even when Peter Reith opened up the debate on a corporations-based federal regime, he made it clear that such a system should not override agreements registered under laws like those in force at the time in Western Australia (Reith 2000d, pp. 18–19). No attempt was made to explain how that exception would be consistent with the goal of eliminating 'duplications' and 'inconsistencies' between federal and state systems.

Indeed I have encountered many people in business, in unions and on either side of politics who have long been fearful of any move towards a national system, simply because they are worried about what might happen when 'the other side' (whoever that might be) gain power federally and can shape that national system to their own ends. For these people, state systems are seen to provide 'safe havens' in which some kind of refuge can be taken — whether this is legally or practically feasible at the time or not.

For my own part, I remain convinced that Australia should have a single, national system of regulation, for each of the reasons advanced earlier. Given in particular the small size of our economy and the significant number of businesses that trade in more than one State, nothing else seems to make sense. But I would qualify that with a number of observations.

The first is that the only sensible way to achieve a national system is through federal-state cooperation, just as has happened in other areas such as corporate governance.[19] For the Australian Government to attempt a 'hostile takeover', by expanding the reach of the federal system and then pressuring the States to refer their powers over the non-corporate sector, is to threaten the very efficiency gains that might be reaped from a unitary system, by creating uncertainty and encouraging costly litigation as to the boundaries between federal and state regulation.

18 See *Victoria v Commonwealth* (1996) 187 CLR 416.

19 Ironically, the corporations power has been held by the High Court not to authorise the Australian Government to regulate the incorporation of companies, just the regulation of companies that have already been formed: *New South Wales v Commonwealth* (1990) 169 CLR 482. The result is that the consent of the States is necessary to any national regime for corporate governance.

Secondly, it is hard to see the sense in pursuing a national system of regulation of employment conditions, agreement making and industrial disputation, while leaving the closely related areas of OHS and workers' compensation to the States and Territories. Although the Australian Government has been making moves to allow a few big employers into its own workers' compensation scheme, Comcare (Guthrie, Purse and Meredith 2005), the Howard Government has rejected broader-ranging proposals from the Productivity Commission (PC 2004) for the establishment of a national self-insurance system to compete with the established State and Territory regimes.

Thirdly, and at a broader level, the adoption of a national approach should be seen as far less important than making labour regulation more efficient in terms of simplicity and transaction costs. It is instructive to refer in this context to the 'Checklist for assessing regulatory quality' prepared by the Office of Regulation Review (Argy and Johnson 2003, p. 6). The Office, which is part of the Productivity Commission, suggests that laws that 'conform to best practice design standards' can be characterised by various principles or features. These include having laws which avoid unnecessary burdens or restrictions, are not unduly prescriptive, are 'accessible, transparent and accountable', are 'integrated and consistent with other laws' (including international standards), are clear, concise and written in 'plain language', are 'mindful of the compliance burden imposed', and are 'able to be monitored and policed effectively'. Many federal and state employment laws, but especially the present *Workplace Relations Act*, contravene every one of those standards. Unfortunately, there is no sign that the Australian Government even understands the practical problems this causes for those in business, let alone proposes to do anything about it — as the 700 or so pages of the *Work Choices Act* plainly attests.

There are vast improvements that could be made to our system of labour regulation without necessarily touching the fundamentals of the system or disturbing the existing federal-state balance, improvements that could make our laws simpler, easier to understand and less costly to apply. That, to my mind, should be seen as a prime objective of labour market reform, whatever else 'better' regulation might involve.

7 Functioning federalism and the case for a national workplace system*

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7.1 Introduction

A consideration of how federalism, and the systems of governance it imposes, affect our economic and commercial way of life goes to the very heart of how the nation affects the well being of its people and how its people in turn contribute to the well being of the nation.

In essence, and like any other citizen, our businesses and employers look to governments and the broader community to provide quality systems of institutional governance and regulation that protect and enhance core rights, freedoms and values.

What then should be the federalism compact for the 21st century between the Australian system of governance and its people, including its business people?

There are many dimensions to this question. This paper concentrates on one aspect, the federalism compact concerning the regulation of labour. In other words, regulation of the relationship between a business and its employees, or as we more commonly call it, workplace relations and employment law, or labour law.

The paper has been prepared drawing on the work of the Chamber, which is very much a federal institution in its own right. The Chamber, through its various iterations, has existed for the full period of the Australian federation. Over that time we have been the principal and peak collective institution of Australian employers operating within the workplace relations system and current federal structure (both federal and state systems).

* This paper was written prior to the passage through the Parliament in December 2005 of the *Workplace Relations Amendment (Work Choices) Act 2005*.

Our views seek to combine principle and underlying values with practice. This is our approach on workplace relations and employment matters, as reflected in Australian Chamber of Commerce and Industry's (ACCI's) *Modern Workplace: Modern Future* Blueprint (ACCI 2002). That Blueprint is a ten year policy implementation statement for reform of the Australian workplace relations system. It has informed the general direction of this paper.

The structure of the paper is as follows:

- identifying the division of legislative powers between the Australian and State/Territory Governments in relation to labour market and industrial relations legislation;
- identifying the contemporary impact of this division of power on regulatory coverage of workplaces;
- identifying key labour market reforms since the late-1980s and the extent to which the federalism compact helped or hindered their development;
- assessing the case for change to the constitutional foundations of Australian workplace relations, given the existing division of legislative powers;
- identifying the options for reform, and commenting on the advantages and disadvantages of various alternatives including the current proposals of the Australian Government, and the opt-in option canvassed by the Productivity Commission in its Review of National Competition Policy Reforms;
- assessing the extent to which the doctrine of competitive federalism is relevant in the workplace relations context, and whether state industrial systems in this area act as either a force for beneficial competition or as a safe haven against federal laws; and
- concluding thoughts.

7.2 The existing federal structure on workplace relations

This section of the paper identifies the division of legislative powers between the Australian and State/Territory Governments in relation to labour market and industrial relations legislation. It explains how it is we have six separate labour law regimes in Australia, a country of just ten million employees.

The Australian Government has legislative powers that are established under the Constitution. Some of those powers are exclusive to the Australian Government,

and some of them are shared with the States. All Australian Government legislation must be based on one or more heads of power under the Constitution.

The federal *Workplace Relations Act 1996* is primarily, but not exclusively, based on section 51 (xxxv) of the Constitution. Section 51(xxxv) provides that:

> The Parliament shall … have power to make laws for the peace, order, and good government of the Commonwealth with respect to: … conciliation and arbitration for the prevention and settlement of industrial disputes extending beyond the limits of any one State.

This provision was largely a product of the intense and bitter industrial conflict of the 1890s in maritime and shearing which was fought over the right of unions to bargain collectively with employers, the first of the inter-colonial industrial disputes. At that time there was community pressure for protection of the public interest by the use of compulsory conciliation and arbitration to prevent and settle such conflict, and avoid its disruptive effects.

By the time of federation, all States had established conciliation and arbitration tribunals or wages boards to deal with industrial disputes. However, it was acknowledged at the Constitutional Conventions of the 1890s that the States were ill-equipped to deal with interstate disputes, such as those that had occurred during the 1890s, and that the Australian Government should establish machinery to deal with such matters.

I emphasise three points here.

Firstly, that the power in section 51 (xxxv) was a power of dispute resolution designed to deal with the prevention and settlement of actual disputes. Over time, however (indeed, within two decades), the apparatus of conciliation and arbitration was doing a different task, setting employment standards across industries whether 'on the ground' disputes existed or not. That extension of the constitutional concept into a system of delegated legislation through the making of awards was a distortion of the intent of the founding fathers. It has remained until today.

Secondly, even in a pre-federation colonial environment it was acknowledged that the economy of the day could not sustain State-only boundaries for industrial resolution.

Thirdly, there is an inherently random element of 'interstatedness' built into the power. The constitutional founders saw nothing wrong with the Australian Government having an industrial jurisdiction per se, but limited it to disputes of a certain geographical, or notionally geographical reach. The randomness arises from the nature of the dispute as constructed by the disputants, not the subject matter of the dispute.

Soon after this power was conferred by federation, the Commonwealth Parliament enacted the *Conciliation and Arbitration Act 1904*. The Act set up the first federal industrial relations tribunal, the Commonwealth Court of Conciliation and Arbitration. Its successor is the current Australian Industrial Relations Commission, although many changes have occurred to the body since its inception, including a High Court ruling that the body exercising conciliation and arbitration powers could not exercise judicial power.[1]

Many other important cases have been brought before the Court on the interpretation of section 51 (xxxv). Indeed, it is one of the most litigated heads of power in our federal system. It is not within the province of this paper to analyse this jurisprudence. It is sufficient to advance two related propositions.

One: That the most revealing aspect of the power in section 51 (xxxv), both on its face and from its constitutional history, is that it is a power with inherent limitations if one wanted to establish national labour laws. The specific Australian Government power in section 51 (xxxv) is narrow in comparison to the full plenary power of the State Parliaments. The States have general powers over all industrial matters in their jurisdiction, subject to section 109 of the Constitution.

Two: Yet equally, its constitutional history tells us that the power has been stretched, strained, contorted and interpreted in such a way that, despite its structural limitations, federal laws now cover over 60 per cent of Australian employees regulated by a conciliation and arbitration system. Almost the entire cohort of those employees are only employed in one jurisdiction, and have no 'interstatedness' associated with their day-to-day work. A key lesson in the history of section 51 (xxxv) is that it has been interpreted and applied in a way that has significantly expanded Australian Government jurisdiction.

As a result, every person in Australia lives and works in a community that is bound by two systems of employment law — the laws made by the Australian Government and the laws made by the Governments of one of the six States and two self-governing Territories. Often these differing laws apply to workplaces of a common character alongside each other in, say, a shopping centre. On occasions even in the one business different occupational classifications of employees are bound to the labour laws of different jurisdictions.

How then are these legislative conflicts resolved? Section 109 provides for Australian Government law to prevail over State law to the extent of any inconsistency. This leads to federal awards and agreements normally prevailing

[1] Boilermaker Case [*R v Kirby; Ex parte Boilermakers Society of Australia* (1955-56) 94 CLR 254; (1956-57) 95 CLR 529; (1957) AC 288].

over state awards and agreements and allows the federal tribunal in particular circumstances to exclude state tribunals from exercising their powers.

Scratching beneath the surface, the system becomes much more complex. There are limitations rooted in the power itself. Under the conciliation and arbitration power:

- the Australian Parliament cannot directly legislate on workplace relations — it can only provide for third party tribunals;
- the tribunals set up by the Australian Government can only use particular mechanisms (conciliation and arbitration) for particular resolutions (prevention and settlement) to particular types of disputes (which must be both 'industrial' and 'interstate' in character); and
- the Australian Government's power is not comprehensive, and inherently overlaps with the States.

The limitations inherent to section 51(xxxv) of the Constitution have led to fundamental structural and procedural problems:

- There are difficulties in ensuring effective safety net coverage and maintenance and focusing awards on the provision of a minimum safety net.
- Constraining the determination of wages and employment conditions to a dispute resolution paradigm even though workplace disputes are not the norm.
- The inability to make common rule awards means that federal award and safety net coverage is less than complete. In some cases state awards operate in the gaps, but there are also award free employees.
- The federal-state division of powers inherently undermines the system's foundations, resulting in duplication, associated legalism, costs, inefficiencies and confusion.
- The mechanisms developed to apply the outcomes of safety net reviews and test cases are cumbersome and inefficient, reducing the effectiveness of the federal safety net for large numbers of employees.
- Long and detailed awards developed in settlement of particular disputes over numerous years add to the complexity of the award structure, compounding confusion about rights and entitlements.
- The cost and inefficiency associated with maintaining multiple tribunal, registry and enforcement arrangements.
- The confusion, cost, complexity and legalism associated with jurisdictional issues with employers and employees moved from one system to another, or not even knowing they have been moved.

- The award structure is complex, including more than 4500 federal and state awards and occupational awards covering a large number of workplaces in many industries.
- Procedural problems, duplication and costs arise because many employers have to deal with more than one award and with dual systems applying to a single workplace.
- The existence of near identical federal and state awards governing the same industry or the same work also contributes to compliance problems arising from confusion about which award applies to any particular employer or employee, and about employees' rights and entitlements.
- The complexity of the system has become a tool that the major players use to their own advantage from time to time, but which does little to encourage constructive and cooperative relationships.
- Such a system can be confusing and alienating for parties unfamiliar with the nature of the game, and unable to participate in its processes because of its perceived complexity and cost.
- The existence of more than one tribunal regulating the same broad subject matter is a potential cause of different outcomes (for whatever reasons — the nature of the submissions made or led, the guiding principles used or the perceptions and values of different individuals). The different outcomes can result in workplace relations difficulties, impressions of unequal treatment and a lessening of confidence in the overall system.

These limitations have strongly influenced the nature, scope and operational characteristics of the federal system. Over many years of operation, procedures have developed that have modified the impact of some of these limitations. But these procedures have contributed to cost, confusion and complexity — they have been 'highly artificial, filled with legal fictions, and difficult to explain to those unfamiliar with the complex workings of the system'.

For example complex and costly procedural arrangements (involving the notions of respondents, logs of claims, roping in, ambit and paper disputes) have been contrived to overcome the inability to make common rule awards. Such arrangements have encouraged an adversarial system, divorced from the resolution of real issues at the workplace. Processes such as extravagant ambit logs of claim are inherently alien to the workplace, and immediately bring the system into disrepute.

The most potent policy objection to the current constitutional arrangements is not the mere unworkability of the power, but its lack of inherent logic in application and relevance to the national (indeed global) nature of the Australian economy.

It is a power based on the existence (that is, creation) of a dispute as the foundation for the conferral of jurisdiction. This alone is a suspect concept if legislative power is to be used for minimum standard setting and agreement-making purposes rather than inter-parties dispute resolution. Also counter intuitive is the notion that a power to settle disputes has come to rely on the creation of disputes that did not otherwise exist.

Coupled with the complexity and uncertainty arising from its tortuous legal contortions, it is a very poor footing for contemporary labour regulation.

I should not depart from a consideration of the current constitutional foundation without making reference to other heads of power. Whilst the conciliation and arbitration power is the primary head of power in use, the current federal law uses other powers, notably:

- the Territories power[2] (allowing for full plenary power in the two Territories);
- the incidental power[3] (allowing, amongst others, regulation of industrial organisations);
- a State referral of power[4] (allowing for almost full plenary power in the State of Victoria); and
- the corporations power[5] (allowing for laws regulating dismissal disputes with corporations, and agreement making on industrial matters with corporations).[6]

The latter two of these heads of power are relatively recent in their use, since 1993 and 1996. In addition, in 1993 the treaties power in respect to 'external affairs' was used as the foundation for the Australian Government's then unfair dismissal laws via the controversial (and convention-breaking[7]) ratification of Convention 158 of the International Labour Organisation by the Keating Government just prior to the 1993 general election. The use of the treaty power to underpin industrial matters was discontinued by the Howard Government since 1996.

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2 Section 122.

3 Section 51 (xxxix).

4 Section 51 (xxxvii).

5 Section 51 (xx).

6 The trade and commerce power in section 51 (i) has also been used for very limited purposes.

7 Ratification occurred by the Australian Government in February 1993 without notice to, or consultation with the States. This breached treaty making conventions that had existed prior to this date. The convention requiring notice and consultation was subsequently reinstated into Commonwealth practice.

7.3 Coverage of workplaces under existing structures

Despite what section 51 (xxxv) appears to mean on its face, it is not simply employees that work across State boundaries, or businesses that trade across State boundaries that are covered by federal laws.

Nor is the distinction clear or obvious in the public sector. It is not the case that public sector employees of a state are employed under the laws of the state and federal public sector employees employed under laws of the Australian Government. Many thousands of state public sector employees are employed under Australian Government laws.

Just as existing constitutional arrangements create legal and operational confusion, the random and changing nature of coverage between federal and state labour laws is not conducive to any exact data on coverage levels.

This is not new. As far back as 1985 an inquiry into industrial relations law and systems commented that:

> The recent survey data indicate a confused situation as to the coverage of particular industries and occupations by both federal and state industrial tribunals, and widespread divergences in the incidence of federal awards from one state to another. There is often no rationale or clearly established basis why a particular workplace is covered by a federal award or a state award. Indeed there are many workplaces where some employees are covered by federal awards and some by state awards. This characteristic of the system is a source of concern and can only lead to confusion and uncertainty….(Hancock 1985, paras. 6.13–6.14)

The consequence of this can be profound for employees and employees. The celebrated example of a country motel used publicly by former Australian Government Minister Reith in 2000 is telling. In that case a country motel in New South Wales had employed staff for many years under a NSW state award. Upon acquiring the business the owners checked their award coverage with the NSW inspectorate based in the relevant State government department. They were advised that they were to pay under a NSW state award. Four years later, and following a grievance by a former employee, the motel owner was told by the Australian Government department that years before they had been roped into a federal award following a union log of claims. The result was an underpayment of wages bill of over $20 000 — in circumstances where the employer and its employees were never in dispute and did not consider themselves to be doing anything other than paying and receiving the legally required wages.

On all principles of regulatory design, the system failed this workplace. Aside from one's moral responsibilities, if regulators had a legal duty of care to the parties for good regulatory policy they would be culpable.

If employers, employees and even government departments cannot reliably know which laws of what jurisdiction cover which workplace then it is apparent that estimates of coverage will only ever be informed guesstimates.

Further, whilst measures of coverage have traditionally concerned coverage of awards made through the conciliation and arbitration system, this is arguably a poor measure in an era where agreement making is both a legislative and workplace reality.

What can be said reliably is that in the State of Victoria and in the two territories[8] the one system of federal laws alone applies insofar as the regulation of employer/employee relationships is concerned.[9]

In all other States there is a divided federal-state jurisdiction. Best estimates of federal coverage in these jurisdictions varies from about 45 per cent in South Australia to about 65 per cent in New South Wales.

In addition, any corporation making an agreement with its employees and having that agreement certified or approved under the federal law is bound by the federal law.

Hence, even where a state law currently covers a workplace where the employer is a corporate entity, that workplace can become covered by federal law simply by act of the workplace parties without any legislative change. This randomness of changes to coverage by agreement-making is much the same as the consequence of a state award governed workplace becoming a federal covered workplace through the notorious process of a union log of claims and subsequent dispute finding and roping in order.

This characteristic of the system was amply demonstrated in recent years when following the election the Gallop Government in Western Australia in 2001 and its repeal of the Court Government's workplace contracts legislation, a flight of employers and employees moved out of the state system into the federal system by making Australian Workplace Agreements (AWAs). This was clearly evident in the mining industry, although not limited to that sector. This change in jurisdictional coverage occurred not through the traditional form of award roping in, but through the agreement making system, a system based on section 51 (xx) of the Constitution, the corporations power.

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8 The Australian Capital Territory and the Northern Territory.

9 With the exception of annual leave, long service leave, health and safety and workers compensation laws; and in Victoria a small cohort of employees necessary for the operation of the State remain bound by State laws.

The best estimates of coverage are that approximately 60 per cent of Australian award covered employees are currently covered by federal laws, either through awards made or agreements registered under those laws.

It is further estimated that another 25 per cent could be covered by federal laws by accessing provisions of federal law based on the corporations power, bringing total coverage using both the corporations power and the conciliation and arbitration power to 85 per cent of employees (Reith 2000b, 2000c).

7.4 Federalism and past labour market reforms

This section of the paper seeks to identify key labour market reforms since the late-1980s and the extent to which the federalism compact has helped or hindered their development.

There has been a bipartisan policy trend in Australia away from the centralised determination of the wages and conditions of employees, and towards the making of workplace and enterprise agreements, subject to an underpinning minimum safety net. In the 1990s the need to make workplace and enterprise agreements a key element of the system was endorsed by both major political parties, all major employer associations, the Australian Council of Trade Unions (ACTU) and most individual unions.

The former Prime Minister, the Hon Paul Keating MP, said in 1992 that:

> For well over a century, Australia has attracted the interest and curiosity of practitioners and theorists of industrial relations. In the great constitutional debates of the 1890s our founding fathers gave the proposed Commonwealth a power to settle interstate industrial disputes by conciliation and arbitration. When we became a nation in 1901, one of the first things we did was to set up a Commonwealth tribunal which could exercise this power to settle disputes – a power which rapidly became one of setting wages and conditions directly or by example for most Australian employees.
>
> It was a system which served Australia quite well I think, but the news I have to deliver today to those of our visitors who still think Australian industrial relations is run this way, is that it is finished. Not only is the old system finished, but we are rapidly phasing out its replacement, and have now begun to do things in a new way. (Keating 1992)

Australia needed a more flexible labour market to maximise economic growth and employment opportunities and to maintain and improve our standard of living in an increasingly globalised economy. Responding to these imperatives, workplace relations legislation at the federal and state levels underwent significant reform.

The *Industrial Relations Reform Act 1993* provided an increased emphasis on agreement making at the enterprise level.

The *Workplace Relations Act 1996* went significantly further, making agreement making the focus of the system. It provided access to new and more simple forms of agreement, including new forms of collective agreements as well as AWAs which can be made between individual workers and their employers.

Legislative changes which increased the emphasis on agreement making at the enterprise or workplace were also made in all the States in the late-1980s or early-1990s. Some States (Victoria, Queensland, Western Australia) passed legislation to provide access to agreements with individual employees. Following changes of government in the mid to late-1990s, some States modified their workplace relations legislation, but in no case has this involved the abandonment of statutory provisions for workplace bargaining.

Hand in hand with the trend towards agreement making has been the development of the concept of the safety net. Changes have been made at the federal level to ensure that awards are increasingly focused on providing a safety net only of minimum wages and conditions and no longer are intended to be comprehensive regulatory instruments regulating market rates and conditions. Federal awards have been simplified (albeit imperfectly) to provide a safety net and a baseline for agreement making at the workplace and individual levels.

Yet there remain 4500 federal and state awards for just over eight million employees.

Aside from awards, state and federal legislation has been a vehicle for establishing a number of minimum entitlements of employees, some of which apply to all employees across Australia. These include rights in relation to unlawful termination of employment, long service leave, equal remuneration for work of equal value, parental leave and freedom of association. These rights are established directly by legislation and not under awards. Because of the limitations of the conciliation and arbitration power, these rights in federal law have not been able to be based on that power, and have instead been based on other heads of power under the Constitution.

The 1993 and 1996 changes to the industrial system followed the opening of the Australian economy to global economic forces in the 1980s, and were a response to it. Two policy imperatives identified at that time were:

- the industrial system had to go beyond the regulation of employee entitlements and drive productivity, efficiency and business competitiveness; and

– Australian workplaces operated in both a national and global economic setting and had to achieve efficiencies of scale in a global market for both capital and labour.

The fundamental policy paradigm in Australian workplace relations changed from awards to agreements, from tribunal intervention to workplace determination, from dispute settlement to enterprise bargaining.

This has significant ongoing implications for the constitutional foundation of the system.

It is self evident that the head of power in section 51 (xxxv) requires the finding of an interstate dispute and awards made in settlement of that dispute. It is a constitutional power based on the old paradigm of adversarialism, disputes and tribunal intervention. The policy making imperative moved on more than a decade ago, but the constitutional paradigm has not.

A new system is being grafted on an old head of power. That head of power is manifestly inadequate, and demonstrably so, evidenced by the more recent use of the corporations power to leverage the move into agreement making and away from awards.

Aside from the case for change based on the inherent weaknesses of the conciliation and arbitration power, the policy change to the industrial system since the early-1990s, based as it is on the economic change and challenge confronting our nation, is a powerful argument in its own right for a fresh approach to the constitutional foundation for labour law.

7.5 Assessing the case for change

Thus far, this paper has argued that the inherent limitations on the constitutional power in section 51 (xxxv), coupled with the legal contortions to extend its reach, have created an irrational basis for the current reach of Australian Government coverage even allowing for the random nature of that coverage in the first instance, and that it is out of sync with policy development.

The next question which arises is whether these deficiencies with the current constitutional power are sufficient to warrant a change in the constitutional foundation of the system?

The limitations of the conciliation and arbitration power are clearly linked to a number of undesirable outcomes that have emerged over the last century:

- there are difficulties in ensuring widespread and effective safety net coverage and compliance;
- the body of regulation is of poor quality;
- there is wasteful duplication and complexity involved in the operation of a federal and (currently) five separate state workplace relations systems; and
- cumbersome, complex and costly procedures have developed that are confusing and alienating for employers and employees unfamiliar with the rules of the game.

As noted, a multiplicity of awards within single industries and workplaces can lead to difficulties in managing workplaces efficiently and to difficulties in achieving workplace reform through bargaining. Problems arising from a multiplicity of federal awards are compounded by the multiplicity of systems and tribunals. Multiple systems increase the probability of different standards or principles applying in the same industry or workplace. As noted, it is not uncommon to find federal awards applying to some employees in an establishment (for example maintenance and production workers) while state legislation and industrial awards apply to other workers in the same establishment (for example clerical and transport workers). A federal-state award workplace is more costly for the employer to administer, creates the possibility of disharmony and instability in the workplace, and contributes to enforcement problems.

A comprehensive agreement that overrides all or most of the terms and conditions of relevant awards may be used to reduce or remove the necessity to refer to multiple awards for the duration of the agreement, but may not be easy to achieve.

There are costs and inefficiencies associated with the maintenance of duplicate federal and state systems, including tribunals, registries and enforcement arrangements. In addition, the existence of federal and state systems inevitably raises jurisdictional issues, which can be costly and difficult to resolve, and can result in delays in handling the real issues in dispute, and increase legal costs. The operation of more than one tribunal can also encourage 'forum shopping' where parties seek to gain from another tribunal what they have been denied or refused in their traditional area of industrial coverage. Such moves are also commonly associated with costly legal argument about jurisdictional issues.

The parallel operation of different federal and state tribunals and federal and state legislation leads to confusion and uncertainty about the rights and obligations of employers and employees. Such a situation benefits no one and creates unnecessary difficulties and technicalities in the labor inspection and enforcement processes.

As noted, section 109 of the Constitution allows for Australian Government law (including federal awards and agreements) to prevail over state law to the extent of any inconsistency. However, determining what constitutes 'inconsistency' is no easy matter, and the Courts have not always been consistent in their approach to this issue. This can result in difficulties and confusion about which law to apply, for example where there is an overlap between state employment protection laws and federal award provisions.

Uncertainty about award entitlements can arise from factors such as the length and complexity of many awards, the difficulties of determining respondency, and duplication of systems. Many employers are unaware that they are covered by awards. Some employers are also not aware when their state awards are superseded by federal awards.

Such factors contribute to confusion about which award and which entitlements apply at a particular workplace or to a particular employee and raise enforcement issues.

Difficulties arise by reason of federally registered organisations being incorporated bodies and their branches in certain States also gaining corporate status and a separate identity through their registration within the State systems. Serious complications and legal difficulties can arise where two legally different bodies, governed by different laws, are operated as if they were a single entity. Such problems commonly come to the surface in the context of a factional struggle within a union, when one faction may seek to exploit past irregularities through legal action to gain the upper hand, or disputes ownership or control of assets. Despite federal legislative reforms aimed at addressing the problems created by dual registration, the problems remain largely because the majority of States have not passed complementary legislation.

The multiplicity of jurisdictions and registration processes has contributed to demarcation disputes. Overlapping industrial jurisdictions have also prevented resolution of some issues by any one tribunal.

Despite some progress, the workplace relations system is still very complex and further reform to make the system simpler, more accessible and more effective has been hamstrung by reliance on the conciliation and arbitration power. Reliance on that constitutional power prevents the achievement of a more coherent national framework of laws.

During the past twenty years two substantive assessments of this question have been made by governments of both political persuasions.

In 1983 the incoming Hawke Government established a Committee of Review into Australian Industrial Relations Law and Systems, known as the Hancock Committee. One of the Committee's terms of reference required it to examine the extent to which federal and state industrial relations arrangements might better inter-relate. It reported in 1985.

The Committee saw advantages in a unitary system of industrial relations '*whereby in either Australia as a whole or in any given State or Territory, the system of regulation was under the exclusive control of one authority*' (Hancock 1985, p. 270). But it came to the conclusion that moving to unitary or exclusive regulation was not practical in the short term. Instead, it advocated other options involving greater coordination and cooperation between systems, through mechanisms such as dual appointments, closer contact and consultation between tribunals, and more uniformity of procedures and provisions.

It also gave support to the concept of an 'integrated system' where a central repository of power enacted one law but where it was administered by State arms of a national tribunal.

It made a number of pertinent observations about the case for change, including the following:

> … if the constitutional limitations on the Commonwealth's industrial relations power produced no more than irritating legalisms and a need for parties to follow particular procedures, it might be said that the requirements should be 'lived with' as not affecting the substance of the relationship between the parties. The problem, however, goes deeper. It involves the issue of whether parties operating within the federal system should be able to have the full range of matters and dealings between them regulated by the federal industrial tribunal. (Hancock 1985, para. 6.7)

This view is all the more forceful when understood that it was made before the opening of the Australian economy to global competition in the late-1980s and the bipartisan policy move towards enterprise bargaining in the early-1990s.

The second substantive Commonwealth examination of the issue was by the Howard Government under the stewardship of the then Minster Hon. Peter Reith MP. Minister Reith issued a series of four discussion papers in 2000 under the theme 'Breaking the Gridlock: Towards a Simpler National Workplace Relations System' (the Reith Papers). In releasing those discussion papers, the Minister argued that:

> … the use of the conciliation and arbitration power as a basis for the existing system has bedeviled policy makers for many years, and created a gridlock of process and legal fictions that leave employers and employees out in the cold with less than optimum workplace outcomes. That is clearly an unsatisfactory situation. The system has become one where third parties and the so-called experts have been the privileged few

> on the inside who know how it works and how to work it. In particular, it is argued that the system has not worked well for small business and its employees. In addition there are serious equity issues. The discussion papers outline how some 800 000 Australian employees fall between the gaps in award protection under the current six (and potentially seven) different workplace relations systems. They argue that the safety net of minimum standards could be improved if the corporations power was used as the basis of the system….while the Federal Government has made no policy decision to adopt such a proposal, it justified serious public analysis. (Reith 2000a, p. 1)

Practical reform of federal-state relations in this area (and perhaps more generally) is also important to continuing the economic growth of recent years.

The Commission of Audit commissioned by the incoming Howard Government in 1996 had as one of its terms of reference:

> … The Commission should focus on identifying duplication, overlap and cost shifting between the Commonwealth and state/territory tiers of government in delivering services, and recommend measures to promote more efficient service delivery, having regard to the need to improve outcomes for clients and value for money for taxpayers. (Australian Government 1996, 2(vi))

In its final report, the Commission concluded:

> … Reducing program duplication and overlap simply requires a clear delineation between levels of government as to program responsibility.
>
> Ideally, elimination of duplication and overlap would require complete responsibility for a particular program to lie with one level of government only.
>
> Where this can be achieved, effective and efficient program delivery is more likely. In general, the prospects of success may depend on whether different levels of government can agree about which level should take complete responsibility for the program. (NCA 1996, section 4.4)

In a speech that strongly advocated the case for change delivered to the Sydney Institute in July 2005 (and which echoed a sentiment of former Federal Attorney-General and then Prime Minister Hughes ninety five years earlier[10]), the current Prime Minister put it this way:

> Six different industrial relations systems is an anachronism for a nation of 20 million people in a region that will be the world's economic centre of gravity in the 21st century. Our overlapping systems reflect a time when businesses operated within State boundaries; when our politics were more concerned with walling Australia off from the world, rather than competing in it. (Howard 2005d)

10 'Clearly industrial matters are not provincial or State concerns, but of national importance. Industry concerns us all; its ramifications are co-terminous with the boundaries of our continent…The industrial question is in its essence national, although it has phases peculiar to localities, districts and States...We cannot deal with the industrial question like mites burrowing and hiding themselves in the recesses of a cheese.' (Hughes 1910)

It has not been governments alone that have promoted the case for change. Australian industry, as it has developed a national and global character, has called for efficiencies in many systems of governance, including the federal division of power on employment matters. In a relatively small economy, and given international competition, such efficiencies are not optional extras.

In the period between 1992 and 1994 many employer association participants in the system made a number of far reaching policy decisions that changed the paradigm through which the organised employer movement operated in the industrial system. Via the forums of the Confederation of Australian Industry, and its successor the Australian Chamber of Commerce and Industry, the employer movement at a collective national level adopted a policy in support of a single national system 'through complementary federal-state legislation or, in the absence of such legislation, through other means'. This policy framework remains today.

In 2002, impatient with the then lack of national progress in this debate and on labor market change more generally the ACCI, again through the employer movement constituency, released a ten-year plan for the implementation of its policy. That plan, known as the 'Modern Workplace: Modern Future Blueprint 2002-2010', has become a template for reform, including some of the reform issues currently on the parliamentary agenda. On the issue of a national industrial system, more than 30 employer bodies adopted three broad recommendations (ACCI 2002):

(a) The case for moving towards a harmonised national workplace relations system should be assessed in a nine-step orderly development phase that involves a national summit, a national taskforce and, if proceeded with, a special meeting of CoAG.

(b) The scope to move towards a harmonised national system could be tested by creating, in the interim, a more uniform national system covering issue specific subject matters in appropriate areas as and when they come before the parliament.

(c) There should be no net increase in the regulatory burden created by a harmonised national system, and the move towards such a system should be designed to reduce regulatory burdens created by duplication and compliance with existing multiple systems.

The Blueprint argued in favour of these recommendations in the following terms:

> Not only does the current mix of federal and state systems operate in an incoherent legal manner, the scope and reach of each system rises and falls depending on court interpretations of constitutional powers, on the willingness of different parliaments to legislate using the full extent of their powers, and the extent to which trade unions manufacture interstate paper disputes and create federal jurisdiction over a workplace through ambit logs of claim and interstate dispute findings. Whilst the federal award

system operates on the basis of respondency (a concept increasingly undermined by concepts of transmission), state award systems operate on a common rule basis.

In addition, the federal system uses different constitutional powers for different purposes. Unfair dismissal laws are a mix of the corporations power, and the territories power. Agreement making provisions are a mix of the corporations power and the interstate dispute power. Federal awards still rely on the interstate dispute power except in Victoria (which uses a referred power) and the ACT and NT (which use the territories power to create federal common rule awards in those territories only).

The limited, piecemeal and ad-hoc usages of constitutional powers provide an environment for a system of regulation which is more complex than it should be — with different minimum standards and regulatory instruments, different rights and obligations, different choices and restraints applying to different workplaces in the same industries. Whilst this is a major problem for nationally operating businesses, it is not exclusively their problem. The scope for wholly intra-State operating businesses to be roped into the federal system (or less likely, out of it) is substantial, as is the scope for State businesses with differing corporate structures to be bound be different jurisdictions for different industrial purposes (eg. unfair dismissal laws).

This also means that the standards and regulatory regime that is imposed on one workplace today may not be the same as the system that is imposed on that workplace tomorrow. Third parties (unions, the federal commission) can alter the very jurisdiction under which rights and obligations are formed, at their discretion, and over the opposition of employers and employees in a workplace – and even without their direct knowledge or input in the decision-making.

It is also apparent that standards in the federal and state systems are increasingly diverging, particularly with the current use of certain state systems by trade unions to advance particular industrial objectives. This divergence in standards increases compliance costs for employers that employ workers across State borders. (ACCI 2002, p. 40)

The ACCI Blueprint did, however, issue some notes of caution:

It is important that a national harmonised system not be seen as an end in itself. At the end of the day, it is the scope that employers and employees have to build direct relationships and exercise choice in agreement making and association that matters. The content of any harmonised system will have a greater impact on outcomes for business people and working people than the harmonised system itself.

The case for moving towards a harmonised national workplace relations system could be assessed in a nine-step orderly development phase. The objective would need to be to focus on exploring the concept with the maximum possible bipartisan national support, and in a constructive non-political manner. An open-minded approach would need to be adopted, particularly by governments (federal and state) — with a recognition by all parties of the legitimate role each jurisdiction has historically had and currently exercises in the system. The initial focus would have to be on confidence building and an objective analysis of options and models for change — without

> requiring any interested party to commit a position or formulate definitive policy during the development phase. At the end of the day, the content of the system will determine whether it has acceptance by employer and employee interests. (ACCI 2002, p. 41)

Events have moved forward since 2002.

In May 2005, current Prime Minister Howard announced that:

> ... the Government believes that a single set of national laws on industrial relations is an idea whose time has come…The government will work towards a unified national system in a cooperative manner with the States. Our preference is for a single system to be agreed between the Commonwealth and the States…In the absence of referrals by the States, the government will move towards a national system by relying on the corporations power in the Constitution. (Howard 2005a, pp. 41–42)

The July 2005 CoAG meeting and subsequent ministerial council meeting made it clear that in the current climate a cooperative approach for rational dialogue between the Australian and State Governments on referral of industrial powers is unlikely, at least not this side of a High Court challenge to the Australian Government's proposed use of the corporations power.

In October 2005 the Australian Government subsequently released further details of its proposal for one national workplace relations system in Australia (Australian Government 2005).

7.6 Options for reform

This section of the paper seeks to identify the options for reform, and comments on the advantages and disadvantages of various alternatives including the current proposals of the Australian Government, and the opt-in option canvassed by the Productivity Commission in its Review of National Competition Policy Reforms.

The limitations of the conciliation and arbitration power have been recognised by successive governments. There have been multiple advocates on both sides of the industrial and political divide who have advocated a unitary or national system of workplace relations and labour law regulation in Australia.

As early as 1920 Mr. Justice Higgins stated:

> Here are two rival tribunals – one constituted by the Commonwealth and one constituted by a State handling the same subject matters independently….the disputants are only too apt to treat the courts as rival shops. This position involves great danger to industrial peace….But I cannot see how the position can be avoided without a change of the Constitution. (McKay v AWU (1920) 14 CAR 364 at 369)

In a February 1998 speech, Justice Giudice, the President of the Australian Industrial Relations Commission commented that it 'is surely time to reassess the Hancock Committee's conclusion that a unitary system is an unattainable objective' (Giudice 1998). His Honour went further in 2001 when he said:

> Our regulatory framework should be designed in a way which accords a high priority to consistency of treatment…There is an important related issue concerning minimum standards referred to in Federal industrial legislation as the award safety net. A great deal has been done in the last 20 years or so to coordinate many basic entitlements through the state and federal industrial award systems. But there are still differences in the nature and level of entitlements. Where those differences have no rational basis but are accidents of industrial or political history they advantage some citizens and disadvantage others. This too is a lack of equality and it undermines our society in a significant way. (Giudice 2001)[11]

In 2002, a prominent union leader, Australian Workers union (AWU) National Secretary Bill Shorten told the National Press Club:

> Variations in State laws are also time consuming and frustrating for employers. It is ridiculous there are more than 130 pieces of state and federal legislation pertaining to industrial law…we believe the ALP with its coast to coast governments is in a unique position to improve legislative uniformity…Now is the time when Australia has the opportunity to lift our standards and have 'best practice' legislation in every State. (Shorten 2002)

The challenge has been, and remains, for the advocates of constitutional change to not only demonstrate that the system is not working effectively or operating well below optimal results, but to also articulate viable alternatives.

The least intrusive model is to retain multiple systems and sources of power but to seek harmonisation of administrative arrangements and policy consistency in key areas.

In practical terms this is what governments took from the Hancock Committee and through the processes of the Labour Relations Ministers Council (now Workplace Relations Ministers Council) in the 1990s there were a number of legislative and administrative initiatives to encourage a more cooperative approach. These included: joint sittings, concurrent appointments, regular meetings between federal and state tribunal and registry members to discuss matters of mutual concern, referral of industrial disputes between jurisdictions, and provisions to empower the Commission to refrain from dealing with a dispute which would be more properly dealt with by a state tribunal.

11 These remarks were specifically endorsed by a Full Bench of the AIRC in a decision of 7 August 2002 Re: Minimum Wage Orders [Print PR 921046].

However, in practice, it was only where a strong conjunction of common political colours existed between the Australian Government and a majority of the States that any real policy progress was made at a collective level.

The high water mark of policy harmonisation whilst retaining dual systems was reached in the mid-1990s when the Queensland State Government amended its State laws to almost directly reflect the Howard Government's 1996 Act. History has shown that such harmonisation initiatives are at the mercy of changes in political complexion. The Beattie Government, even during its early minority years, changed the harmonised State laws to differ materially from that of the Howard Government.

In administrative terms harmonisation is now hardly a serious topic for discussion at the ministerial council. The movement towards tribunal co-location, registry sharing and dual appointments in the mid-1990s has dried up, and politicians make a virtue of differences in approach not common approaches.

It can be safely said that the processes of policy or administrative harmonisation have hardly moved further since the mid-1990s. The initiatives that were taken barely scratched the surface of the inconvenience and expense caused to parties by dual jurisdiction and have, at best, had a marginal impact.

Those seeking to overcome the problems identified by Hancock Committee or the Reith Papers need to go beyond harmonisation, into a consideration of the Constitution itself to identify options for expanded, if not exclusive, Australian Government regulation.

Prior to doing so, I should mention for the sake of completeness one other option — that of, exclusive State regulation, where there would be just one set of labor laws in each State with the Australian Government vacating the field and repealing its own laws. It is an option that was seen as both undesirable and impractical by the then Hancock Committee in 1985, and with the increasing national and global nature of the economy since, even more so in this century.

In the industrial context there appear three options for expanded, if not exclusive, Australian Government regulation:

- constitutional amendments;
- further referral of power; and/or
- wider use of existing heads of power.

The first option can be dismissed for the purposes of this paper on the basis that history tells us that constitutional amendment on a substantive issue such as the heads of power in section 51 is rare indeed. It is easier to sell fear than reason,

especially in the industrial context. A referendum to amend section 51 (xxxv) is unlikely to succeed. I do not think much has changed since the Bruce Government tried unsuccessfully to do so in the 1930s, other than perhaps the heightened preservation instinct of the politicians of the current day.

This means that the second option (referral) and third option (wider use of other powers) present as more viable alternatives.

Referral of State powers relies on section 51 (xxxvii) of the Constitution, which provides as follows:

> The Parliament shall, subject to this Constitution, have power to make laws for the peace, order and good government of the Commonwealth with respect to: ... matters referred by the Parliament or Parliaments of any State or States, but so that the law shall extend only to States by whose Parliaments the matter is referred, or which afterwards adopt the law.

When the Hancock Committee reported, the reference of State powers was considered unlikely. It appears from the Hancock Report that among the State Governments of that time, only the Victorian Government was prepared to entertain the idea of referring powers to the Australian Government, and only for a trial period. As a consequence, the Committee expressed a 'very great doubt that any of the States would be prepared to hand over its industrial relations powers to the Commonwealth' (Hancock 1985, para. 6.59) and did not take this option any further.

This remained the case until Victoria referred the bulk of its workplace relations powers to the Australian Government in an historic development on 11 November 1996. That decision enabled almost all Victorian employees and employers to access the federal workplace relations system without having to satisfy the requirement of an interstate dispute or any other constitutional obstacles. It meant that Victorian businesses no longer faced the time consuming and costly exercise of working with two different workplace relations tribunals or systems. It enabled essentially all Victorian workers to negotiate AWAs and access federal unfair dismissal provisions. This was a major structural reform with mutual benefits flowing from a streamlined system.

It was a referral which contained hybrid forms of regulation within the one framework. In 1999 the incoming Victorian Government, one of a different political persuasion, decided to retain the national system but seek policy change to its regulation in respect to Victorian employees. An agreement was ultimately reached between the Howard and Bracks Governments in 2004 to refer a further State power to make common rule federal awards in Victoria, allowing for a more extensive set

of regulatory standards in those Victorian workplaces which had not been regulated by awards since the early-1990s.

The fact that two governments of different political persuasions reached an agreement to retain (and expand) the 1996 referral on a topic as hot as industrial relations, and did so in a climate where the State Government had legislative capacity in its parliament to withdraw the referral and recreate a State system, says much about the intrinsic logic of a single workplace relations jurisdiction. Both governments are to be given considerable credit for the initiative, although some in industry may question the price of higher regulation paid for retaining the single system.

Allied to the concept of a full referral is the notion of a partial referral of State powers. A proposal for the States to refer powers to the Australian Government to establish a body to determine national minimum standards for some conditions of employment was tentatively adopted at a Premiers' Conference in Melbourne in 1921. The division of authority was to vest in the Australian Government tribunal plenary power to decide on a national basis for all industries, both the basic wage from time to time and the appropriate standard hours of work. State Premiers subsequently came under pressure from their constituents, including from unions who wanted to keep local jurisdictions, and floundered in their resolve. The proposal was dropped.

In the absence of referral of powers, wider use of existing heads of power presents itself as the next best option. The most viable of those options, and the one being pursued by the current Australian Government is the use of the corporations power in section 51 (xx).[12]

Section 51(xx) of the Constitution provides:

> The Parliament shall … have power to make laws for the peace, order, and good government of the Commonwealth with respect to: … foreign corporations, and trading or financial corporations formed within the limits of the Commonwealth.

The corporations power has only been used in the field of workplace relations in recent years, and its scope for regulating corporations remains to be fully developed and tested. It is not an unlimited power. But it is a power that is expressed with greater generality than the conciliation and arbitration power, and the nature of its

12 '*WorkChoices*' will be largely based on the corporations power in the Constitution. In addition, it will rely on other heads of power – the territories power (for the ACT and NT), the referral power (for Victoria) and the external affairs power to support existing arrangements (eg. the unlawful termination provisions).' (Australian Government 2005, p. 11). The government also announced that the conciliation and arbitration power is also to be used for a transitional five year period in respect of non constitutional corporations under Commonwealth industrial laws.

limitations are different from those that have conditioned and constrained the current workplace relations framework.

The High Court originally took a narrow view of the scope of the corporations power. In 1909 the Court decided that, although the corporations power allowed the Australian Government to regulate some of the internal workings of corporations, it did not allow the Australian Government to regulate the functions and activities of corporations. The law stood this way for some 60 years.

In 1971 the High Court overturned this approach.[13] The Court held that the corporations power should not be approached in a 'narrow or pedantic' way, and that the corporations power allowed the Australian Government to legislate regarding the trading activities of corporations.

The *Trade Practices Act 1974* was subsequently based on this power and in a number of minor (but important) respects it dealt with industrial issues — notably provisions carving out arrangements for remuneration and conditions of employment from the anti competition provisions of the Act (section 51 (2)(a)), and prohibiting primary and secondary boycotts (sections 45D and 45E).

The first iteration of the corporations power for specific industrial purposes in a legislative instrument was a private members bill introduced into the Senate in 1983 by Australian Democrats Senator John Siddons. The *Collective Agreements (Corporations) Bill 1983* provided for collective agreements made between corporations and associations representing their employees. A similar bill introduced by Senator Siddons in 1986 proposed that the terms in agreements would be void if they were less favourable than corresponding terms in awards. In both cases, debate on the bills was adjourned and not resumed and the bills lapsed. The Democrats have removed consistent in principle supporters of a national system.

Provision for agreements based on the corporations power was first made by the Keating Government in the *Industrial Relations Reform Act 1993*. That Act continued to provide for certified agreements between employers and unions made under the conciliation and arbitration power, but also made provision for enterprise flexibility agreements made directly between constitutional corporations and their employees. In his second reading speech in support of the 1993 bill former Minister for Industrial Relations the Hon Laurie Brereton MP said:

> Selective use in the federal jurisdiction of the corporations power will allow any matter pertaining to the employment relationship to be covered by agreement. (Brereton 1993, p. 2777)

13 Strickland v Rocla Concrete Pipes (1971) 124 CLR 468.

In those few words Minister Brereton espoused the potential for the corporations power to be the vehicle for a new system based on the then new policy direction of enterprise bargaining.

The Howard Government's *Workplace Relations and Other Legislation Amendment Act 1996* abolished enterprise flexibility agreements and established two streams of certified agreement. The first related to certified agreements made with constitutional corporations. The second provided for agreements made in settlement of industrial disputes or industrial situations.

Further, the Howard Government's legislation also established the system of AWAs based, again, on the constitutional power to legislate with respect to corporations.

Certified agreements and AWAs made under the corporations power have both been extensively used and are widely in operation in all industry sectors in Australia.

What then of the limitations on this power? Decisions of the High Court since 1971 have confirmed that there are at least three clear limitations on the scope of the corporations power.

First, the Australian Government cannot legislate for the incorporation of foreign, trading or financial corporations. Section 51(xx) speaks of corporations 'formed within the limits of the Commonwealth', and the Court has held that this means those 'already formed'.

Secondly, the Australian Government may only legislate regarding 'foreign', 'trading' or 'financial' corporations. These types of corporations are often referred to as 'constitutional corporations'.

Finally, any law relating to a constitutional corporation must have a 'sufficient connection' with such corporations.

It now seems likely that the High Court will shortly be called to rule on the constitutional validity of Australian Government workplace relations legislation using the corporations power (and, I suspect, the incidental power). Such a challenge will test the limits of the power, but to date successive Australian Governments have been confident in their constitutional advice. Tellingly, no State Government challenged the Howard Government's use of the corporations power since 1996, despite their in-principle opposition to the system of AWAs.

As there would be no requirement for an interstate dispute, use of the corporations power would involve the drawing into the federal system of some state-award employers and employees as well as some award-free employers and employees. On the other hand, some federal-award workplaces could move to state award

coverage depending on the transitional arrangements in relation to employers that are not constitutional corporations.

In the Reith Papers of 2000 it was estimated that:

> Using the corporations power and other non-conciliation and arbitration powers, it is estimated that up to two and a half million employees across Australia would gain federal coverage:
>
> - overall, federal coverage could rise from just over 50 per cent of all non-farm employees to more than 85 per cent — and around 90 per cent of all private sector employees; and
> - 69 per cent of all employees who are currently in a state system could be brought within the new federal system.
>
> There are some notable features about this increased level of federal coverage. Currently, around 955 000 employees are award free — that is, they are not covered by a federal award, a state award, or a formalised agreement. By using the corporations power and other non-conciliation and arbitration powers as the foundation for the system it is estimated that around 800 000 employees could be brought within an award system for the first time.
>
> Under a simpler national system, provision could be made to ensure federal award employers are not bound by state awards, so the introduction of genuine safety net awards did not expose federal award employers to more comprehensive regulation by state awards.
>
> While about three per cent of those employees who are currently within the federal system itself would fall out of a corporations power based system, these employees would be covered by state awards or state legislated minima, or a combination of both. (Reith 2000b, p. 24)

It is on this basis that the Australian Government currently estimates that a corporations power system, if constitutionally valid, would cover approximately 85 per cent of Australian employees in a single system (Australian Government 2005, p. 11).

7.7 Competitive federalism and safe havens

This section of the paper assesses two aspects of the debate; the extent to which the doctrine of competitive federalism is relevant in the workplace relations context; and the extent to which state industrial systems on this topic act as either a force for beneficial competition or as a safe haven against federal laws.

It tests the proposition that priority for ongoing industrial relations reforms should be given to conducting it on a jurisdiction-by-jurisdiction basis because (so the argument goes) this promotes improvements through interjurisdictional rivalry or

competition whereas a nationally coordinated approach may lessen inconsistency/diversity but yield a possibly inferior model.

Some pursue this proposition to the point of contending that parties in workplaces should forum shop — choose the jurisdiction of their choice (that is, a competition model).

This is the tenor of an option canvassed by the Productivity Commission in its February 2005 Review of National Competition Policy Reforms (PC 2005f). In that Review, the Commission rejected suggestions that labour market reform be incorporated into national competition policy, but it did endorse the broad thrust of government policy direction in opening labour markets during the past decade. On the question of jurisdictional competition the Review concluded:

> Balancing the potential benefits and costs from competition between jurisdictions on the basis of distinctive features of their labour market arrangements is not easy….At issue in pursuing a national regime is whether it may still be possible to enhance the scope for beneficial jurisdictional competition. For example, consideration could be given to an optional approach like that recently introduced in a more limited scale for workers compensation insurance. Under that arrangement some multi-state employers are able to opt in to an alternative national regime. The efficacy of a more broadly based arrangement of this sort (for employees as well as employers) would of course depend on the detail.
>
> Whatever specific approaches to reforms are employed, for the reasons outlined above, taking advantage of opportunities to make Australian labour markets more responsive and flexible is likely to remain important in enhancing future standards of living. (PC 2005f, pp. 354–5)

A number of observations can be made on this proposition.

Firstly, to the extent that it has been tried, it has not worked. The 1996 amendments to the *Workplace Relations Act* sought to give choices in certain circumstances and had the potential to enliven State jurisdictions accordingly. Whilst these changes provided employers and employees with some scope to choose the jurisdiction in which to operate, such provisions only had a limited impact on a system based on a shared power. Their effectiveness has been almost non-existent, and it was a mistake for the Australian Government to proceed in that manner in 1996.

Secondly, the operation of section 109 of the Constitution and the availability of Australian Government powers (even just the traditional conciliation and arbitration power) does not allow for choice to go back into a state industrial system once roped into a federal system.

Some argue the broader point that duplication of government activity can allow healthy competition among governments, resulting in better public policy. This is known as 'competitive federalism'.

This notion has application in some areas of public policy, but in the context of our existing constitutional arrangements for workplace relations it is a very poor argument.

Competitive federalism in Australia has mainly involved competition between the States. A classic example of this competition was the decision of a past Queensland Government to abolish death duties. But the factors that create a public benefit through competitive federalism in some areas of public policy are not so readily apparent in the area of workplace relations. The constitutional requirement that federal laws and awards override state laws and awards to the extent of any inconsistency, has allowed federal instruments of industrial regulation to override what would otherwise be competitive state regulatory instruments. This has in turn reduced the incentive for States to build significantly different workplace relations systems, and reduced the effectiveness of differences when they have existed.

The evidence suggests that the duplication of workplace relations systems has not resulted in better outcomes for employers and employees, or in an efficient use of resources. The maintenance of dual systems involves additional costs for taxpayers. Businesses face higher costs where they have to deal with multiple jurisdictions, and employees face unclear rights and obligations. Duplication and overlap adds to complexity and confusion. This undermines the effectiveness of the award safety net and creates difficulties for agreement making.

More tellingly, the forced roping in of employers into federal awards and the subsequent pre-eminence of those awards over state instruments has undermined any real scope to choose areas of jurisdiction. Choice is essential to the principle of competitive federalism. Once an employer and employee (individually or collectively) are unable to select a jurisdiction (and to have that choice remain unfettered by third parties), then the scope for competitive federalism to achieve public interest outcomes is fundamentally undermined. For better or worse, this is the consequence of the existing industrial power.

Much of the debate about competitive federalism has resulted from growing resistance to centralisation in government, not only in Australia, but also in other countries. But a national workplace relations system with broader coverage would not need to mean greater centralisation of government.

Consistent with current Australian Government policy, the new national framework could continue to support a more direct relationship between employers and

employees and greater labour market flexibility. Individual and workplace agreements could continue to foster greater innovation and flexibility as the basis for boosting productivity, competitiveness, economic growth and improved living standards, subject to a minimum safety net. This policy shift is empowering of workplaces and is not a centralising one.

Of course this is not guaranteed, and power in the hands of any government has the potential for wise or poor regulatory outcomes.

The report of the National Commission of Audit (NCA 1996) supports the conclusion that the operation of dual federal and state workplace relations systems is not good public policy. In its report the National Commission considered how government could operate more efficiently in specific areas. It found that Australia's dual system of industrial tribunals was 'extremely complex, with extensive duplication and overlap.' It recommended that the Australian Government undertake negotiations with the States to develop greater uniformity and simplification in industrial relations regulatory arrangements.

What then of the contention that a state industrial system can be a safe haven for any employer from a hostile Australian Government and a hostile Australian Government industrial relations policy?

Recent suggestions to this effect by some conservative politicians in some of the States are well wide of the mark and demonstrate a willingness to appeal to an emotive political or State rights audience, and to deny that audience the unpalatable facts.

In asserting that a state industrial system cannot operate as a safe haven I do not seek to be taken on trust, but instead refer to recent history.

In 1992, the Kennett conservative Government was elected in Victoria. At the same time the Australian Government was of a different political colour, the Keating Labor Government. In 1992, the Kennett Government amended state industrial relations laws. Its amendments introduced the most deregulatory state industrial relations system that Australia had witnessed. Its state industrial relations system won praise from many labour market reformers. To the alarm of those conservatives, the Australian Labor Government did not sit back and let this state industrial relations system operate as a safe haven. Instead, the Australian Government used the existing conciliation and arbitration power to amend federal laws to provide a fast track basis by which unions could serve logs of claim on Victorian workplaces and have those workplaces forcibly roped into the federal laws and out of the state laws.

Over the period 1993–96 hundreds of thousands of Victorian workplaces and Victorian employees were forced out of the Victorian system and into federal laws by using the traditional constitutional power of conciliation and arbitration and the constitutional override of section 109 of the Constitution. Moreover, this happened not just in the private sector. The Australian Government override even extended to Victorian State public sector employees — the Kennett Government could not even hold its own State government employees in its State system, let alone the proven sector. It was a safe haven for no-one. The only limit was the ingenuity of unions to seek out and find workplaces not under federal laws. And by using the conciliation and arbitration power, not even unincorporated partnerships under the State system were spared.

A High Court challenge by the Kennett Government, supported by other non-Labor State Governments, was undertaken. In a decision delivered after the Howard Government came to power, the High Court upheld the constitutional validity of the 1993 federal laws.[14] It was only in respect of a very small cohort of employees, those required for the effective conduct and existence of the State, that could not be roped into federal laws. For all of the private sector and 99 per cent of the public sector there is no safe haven for State laws under even the traditional constitutional arrangements.

Similar conclusions can be drawn from the recent history in Western Australia where the Gallop Government has been unable to prevent the flight out of that system by employers and employees making AWAs under federal law. Regardless of which political grouping is in power at which level, the lesson is that state industrial systems are not and cannot operate as safe havens.

On the basis of this analysis, the corporations power, supplemented by other constitutional powers is a viable alternative, albeit not risk-free. Over time, the coverage of the federal system would make the retention of expensive State systems with small coverage that provide no safe haven increasingly unviable.

From an employer point of view, this approach is supported, although industry retains a strong view about the appropriate regulatory nature of the system. A corporations power system that imposed an inappropriate level of regulation on employers and employees, or which turned back the move to workplace decision making would be as objectionable as such approaches under a conciliation and arbitration system (and a corporations power system can regulate more directly, without reference to an industrial tribunal). Corporations-based regulation may be to the good, or to the bad — as may regulation by tribunals.

14 Victoria v Commonwealth (1996) 187 CLR 416.

The corporations power already supports some of the federal workplace relations system, and has reduced some procedural complexity and improved access to formalised agreements. Reliance on the corporations power alone would not allow the federal system to cover all employees, but there would be fewer employees beyond federal coverage than under the current system, and coverage could be increased further by reliance on other powers.

For employers and employees within federal coverage, problems of overlapping federal and state coverage could be removed. Other major benefits include the ability to make awards of generalised application ('common rule' awards) which would substantially improve the effectiveness, simplicity and enforceability of the federal award safety net. The ad hoc, patchy coverage of the current federal award system (with its reliance on identified 'respondents' to awards) would be largely eliminated.

To many in our community, the division of responsibility between State and Australian Governments is not clear. And the community at large detests the appearance of politicking and buck-passing between tiers of government.

To improve service delivery to the Australian people we must aim to ensure that, where practical, one level of government is responsible for the entire delivery of those services on a particular subject matter, especially on a subject matter as basic as the regulation of the workplace.

Yet duplication, divided responsibility, buck-passing and blame-shifting are rife, as much so in the workplace relations and labour law area, as any other area. The community, including the business community, expects clear lines of responsibility, and simpler regulation.

With clear lines of responsibility comes certainty, and with certainly comes efficiency and the sustainability of constitutional arrangements.

Whilst governments (and for that matter unions, employers and commentators) differ widely on the content of a regulatory system for workplace relations and employment law, the Victorian experience is telling us that a single system, once introduced, is widely supported and provides a superior platform for regulatory design.

On economic considerations alone, the recreation of a State system of regulation in Victoria would be a backward step. Spending upward of $50 million dollars each year on duplicating tribunals, inspectorates and dispute settlement procedures is taxpayers money spent on industrial relations machinery that is much better spent on police, schools and hospitals.

This is a reality that must increasingly be brought to bear on the other States, particularly as their state industrial systems have had coverage progressively eroded to the federal system year in, year out.

Current spending by the States of more than $100 million a year on state industrial systems that broadly duplicate the institutional structures of the federal system is a very questionable use of taxpayer funds. It will not be long before State systems simply cover the corner fish and chip shops and milk bars and no workplaces in corporate Australia. At a point it will be very difficult to justify such expenditure, other than by reference to political opportunism or partisan allegiance to vested interests.

7.8 Conclusion

This paper advances five conclusions concerning federalism as it relates to the governance of workplace relations and employment. These are:

- Reforming the federalism compact for the 21st century on workplace relations and employment matters is vital and overdue. Reform should see the establishment of a unitary federal system of labour law regulation, with appropriate checks and balances. Such an outcome is in the national interest, and would enhance federalism.
- A unitary system of labour law regulation is consistent with the evolving nature of the Australian economy, with changes to the direction of labour law and policy since the 1980s and broadly with changes within our society.
- Implementing a unitary system of labour law using a combination of existing federal powers is not the ideal. It is however a realistic alternative that is likely over time to meet the objective of reform.
- Whilst the concept of competitive federalism is meaningful in some contexts, it has only limited relevance in the labour law context, and does not justify the retention of separate state systems.
- That state industrial systems do not and cannot effectively act as a safe haven against either a current or future Australian Government making laws with respect to labour matters.

The intention in re-basing the system should be to move to a simpler national system, not to make change for change's sake.

A shift to a national system is not a panacea to cure all ills, but it is a major structural microeconomic reform. There are some risks, but not greater than the risks inherent in current approaches.

In a country of 20 million people, with less than half the population in the workforce, we can no longer sustain six separate and different workplace relations systems. Australia needs a more flexible and less complex system that focuses on workplaces, not the sources of law. A national government should regulate workplace relations on a national basis, just as it controls taxation, trade practices and corporations. Its central power should be used to decentralise decision making into workplaces, not to enliven regulation at any level of government.

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In commenting on the two key papers by Stewart and Anderson, I initially want to set the scene on the role of labour markets, the performance of the Australian labour market and the case for reform, and provide some background on the current mix of federal and state regulations. My overall assessment is that the speaker papers provide an excellent discussion of the conceptual arguments pro and con a uniform national industrial relations system. However, neither these papers, nor others so far, in my assessment provide a convincing empirical measurement of the net contributions of a uniform national system for improving Australian labour market outcomes.

The principal roles of labour markets are to allocate employees to jobs and for employers to find labour inputs. Employees seek wages and other work conditions which exceed their reservation levels. Employers seek labour inputs so that their marginal value product to them exceeds the payments in wages, other forms of remuneration, and labour on-costs. Reaching mutually beneficial agreements takes time and involves transaction costs. The industrial relations system sets the rules and procedures by which mutually beneficial agreements or contracts between employers and employees are negotiated and administered.

Several aspects of the structure of the labour market generally, and specifically for Australia, are important. First, the preferences and skills of employees and the needs of employers are very diverse, and further, these attributes evolve and change over time. Then, a 'one size fits all' labour contract clearly will be sub-optimal. Inevitably there will be a trade-off between the declining marginal benefits of fine-tuning contracts between smaller and smaller numbers of employers and employees and the marginal transaction costs of greater diversity. Second, there is a lack of consensus among theorists and practitioners on what is a better industrial relations system in terms of such attributes as the degree of centralization versus decentralization in determining labour contracts, the structure of and roles for labour unions, employer associations and third party tribunals, the role for and effects of minimum wages, and so forth (see, for example, Briggs and Buchanan 2005; Moore 2005; Ryan 2005; Wooden 2005b). As evidence of the lack of consensus, we observe quite different industrial relations systems in different countries at any point in time, and changes in the system within a country over time. The principal focus of the discussion today is on the relative merits of a national uniform set of rules for negotiating labour contracts, which is one of the reforms

proposed by the Howard Government, versus competition between state industrial relations systems, and various blends of federal and state regulations.

The current system of Australian industrial relations provides a broad experimental surface of federal, state and mixed jurisdiction regulations. Industrial tribunals of the Australian and State Governments, except Victoria, set wages, hours, penalty rates and many leave provisions through over 4000 awards in what effectively is a mixed system. But, Australian Workplace Agreements (AWAs) are offered only by the Australian Government tribunal. One of the objectives of the Howard Government's WorkChoices (Australian Government 2005) proposal is to replace this mixed system with a uniform national system. While the Australian Government sets the rules on superannuation, the States set the rules for occupational health and safety (OHS) and for workers' compensation. Interestingly, the Australian Government declined to accept a Productivity Commission (PC 2004) recommendation for a uniform OHS. To a large extent, regulations on public holidays are made by the States, and regulations on anti-discrimination are from the Australian Government. This broad experimental surface should provide information relevant for both understanding and quantifying the relative merits of different models of labour market federalism.

How then has the Australian labour market performed, and can a case be made for changes in the industrial relations system to facilitate better outcomes? Against the traditional labour market performance criteria of employment and unemployment, and of productivity and real wages, the last twenty years have been ones of significant gains, but compared with best practice it is also clear that more could be achieved. Of course, other policies, including macroeconomic policies, microeconomic policies towards product markets and capital inputs, and taxation and social security policies, also are important along with industrial relations policies in driving labour market outcomes. The headline unemployment rate has fallen from double digit levels in the early-1980s and 1990s to five per cent in the last year (ABS 2005a). But, the headline unemployment rate does not include the underemployed who make-up about five per cent of the workforce (ABS 2005b; Wilkins 2004), and there is a large number of so called marginally attached to the workforce who report they would enter the workforce if they thought they could gain a job (ABS 2002). Over the 1990s there has been a sharp increase in the numbers of Australians of workforce age who have shifted onto pensions, and, on an international comparison, Australia's employment to workforce population ratio is low when compared with NZ, the UK, the USA and other OECD countries. A closely related issue is the role of the industrial relations system, along with other policies, in setting the NARUI or natural rate of unemployment. There then seems to be considerable scope to increase both the employment level and the effective labour input to face the challenges of an ageing population.

Substantial increases in labour productivity associated with further capital deepening and with increases in multifactor productivity took place over the 1990s, and to a lesser extent in the 2000s (Parham 2005). Real wages tended to increase with the economy-wide average increases in labour productivity and there was an increase in the international ranking of Australian real per capita incomes. However, as shown by the Productivity Commission (PC 2005f) and others, in most parts of the Australian economy labour productivity still is below world best practice, and in many cases 20 per cent or more below the best. That is, as is the case for employment, there is a compelling argument that much more can be done to increase labour productivity, and real wages, particularly in the context of an evolving global economy where other countries are pursuing a range of higher productivity management and worker practices.

Australia's industrial relations system and set of labour market regulations are described by Stewart and Anderson in this conference as complex and involving high transaction costs, and these claims have been made by others. For the purposes of this conference, we need to dig a little deeper into the sources of complexity. In particular, how much of the high transaction costs and rigidities of the present arrangements are due to labour market regulations exercised by the Australian Government or the States, and how much improvement could be achieved by a different or better alignment of federal and state responsibilities? My judgement in reading both Stewart and Anderson is that the former clearly is important, and arguably more important than the issue of federal-state responsibilities.

Consider then the arguments pro and con for a single uniform national industrial relations system to replace the present mixed system with federal and state legislation, regulations and tribunals. The single uniform national system might be effected through the States ceding their rights to the Australian Government, as illustrated by the Victorian move in 1996, by a cooperative Australian Government and States agreement, or by the Australian Government adopting a dominant role. Current political debate suggests that the latter is the only realistic option for the foreseeable future. Specifically, as proposed in its WorkChoices document (Australian Government 2005), the Australian Government intends to use its power over corporations (section 51(20) of the Constitution) rather than its previous heavy reliance on its power over conciliation and arbitration (section 51(35)), and the pre-eminence of Australian Government powers in the event of overlap (section 109). In commenting on Stewart and Anderson, I am in general agreement with their list of pros and cons, but I express doubts that they have made a convincing empirical case for their overall preference for a uniform national system.

Clearly the principal argument advanced by Stewart, Anderson and others for a uniform national system of industrial relations is that it will reduce duplication,

confusion and in general lower the transaction costs associated with the present mixed system in negotiating, monitoring and administrating labour contracts between employers and employees. Further, these savings of costs will flow on to more employment, greater productivity and higher wages. At face value, the claim has to be true almost by definition, but how big are the likely cost savings, and where are the hard numbers? Only about a quarter of the workforce appears to be directly affected by both federal and state jurisdictions. On the other side, without greater cooperation of the Australian and State Governments, the Australian Government's corporations power will not cover from 15 to 25 per cent of employees of unincorporated businesses and of State Government non-corporate agencies and departments. At least over the next few years, uncertainty and costs of appeals against the validity of the Australian Government's use of its power over corporations for industrial relations will add to transaction costs. According to the discussion in Stewart and Anderson, it is arguable that the present federal industrial laws and regulations are more complex and cumbersome than the comparable state laws and regulations. Further, the laws and regulations muted in WorkChoices, and the 700 pages of legislation tabled in parliament, are likely to be complex and costly to comply with (Wooden 2005a).

Potentially, a more detailed comparative quantification of the relative transaction costs of superannuation regulations, which is a national uniform system, with those for workers' compensation, which involves all the States and the Australian Government, should provide some guides. It is not easy to find supporters of simplicity of the superannuation system. On the other side, the Productivity Commission (PC 2004) was not convinced that the extra transaction costs with a mixed system of workers' compensation schemes exceeded the benefits of competitive federalism to the extent of recommending a uniform national workers' compensation scheme, although it recommend a national uniform OHS, a recommendation which governments declined to accept.

It seems almost incontestable that reform of the federal system or of the state systems without changing the federal-state mix offers large opportunities to simplify and to lower transaction costs. For the Australian Government, a particularly interesting comparison could be drawn from the WorkChoices proposal to work with the corporations power rather than the present legalistic and adversarial system developed under the conciliation and arbitration power which both Stewart and Anderson criticise.

Two other arguments are noted by Stewart in favour of a uniform national system of industrial relations. First, particularly with a highly regulated and centralised system of wage setting, such as during the Accord period, some have argued that wages policy is an important instrument of macroeconomic policy management and

therefore should be under central control. As Australia moves further away from such a centralised system to a decentralised enterprise bargaining system of industrial relations, the emphasis on macroeconomic management shifts from control over wages to fiscal and monetary policy on the aggregate demand side and to general microeconomic reform policies on the supply side. The Australian Government still can provide information for jaw-bone, and even threaten retaliatory macroeconomic policies to the enterprise bargainers to base wage increases and other work condition improvements primarily on productivity gains. Second, it has been contended that competitive federalism (in a type of prisoners' dilemma game) would result in a downward spiral of ever declining outcomes for employees. Certainly this has not happened with the competing state systems for OHS and workers' compensation. Given an environment with close to full employment, where employees have the rights and opportunities to voluntarily pick and choose between many employers, and the large number of competitive employers or of large employers with reputations to protect, it seems unlikely that competitive federalism would drive the regulation of work conditions towards developing country levels.

The principal argument against a uniform national system of industrial relations and in favour of competitive federalism is that the competition between the different States and the Australian Government will provide the incentives and rewards for continuous innovation and search for better and even better systems of regulating labour markets. Given the on-going and unresolved debate amongst theorists and practitioners about the relative merits of different designs of industrial relations, for example about enterprise union bargaining over awards versus individual agreements, about minimum wages, about loadings and hours of work, about restricting the number of statutory minimum conditions, and so forth, the case for experimentation to find which systems work better seems compelling. As was the case with claims for the relatively low transaction costs of a uniform national system versus a competitive mixed system, there is a dearth of hard quantitative evidence on the order of dynamic improvements likely to be provided by a system of competitive federalism.

Perhaps further investigation of the time path of improvements in the regulation of superannuation, which is a uniform national system with no competition, with the time path of OHS and workers' compensation, which is a mixed competitive system, can provide some light on the likely benefits of competitive federalism in a closely related area of regulation of labour markets.

Those in favour of a uniform national system appear to presume the Australian Government will choose the best available system. As already noted, there is no consensus on what is the better system even if the Australian Government could

implement its 'first best' solution, and even then could it muster the necessary political capital to implement that system rather than have to resort to a number of 'second best' compromises to gain political support? Public debate and even mistrust (as judged by opinion polls) of the WorkChoices model indicate we likely are in for a 'second best' model (see also Wooden 2005a).

As already noted above, the reliance of the Australian Government for most of its constitutional power on the corporate powers under section 51(20) for its WorkChoices system of industrial relations raises at least two other areas of disadvantage. First, without cooperation from the States, the new system will not apply to the 15 to 25 per cent of employees who are hired by non-corporations or by non-corporate government departments and agencies. The lack of influence over the unincorporated private sector will be especially important for the proposal to remove restrictions on dismissals for firms with up to 100 employees. Until the legal status of the application of the corporations power to industrial relations is fully tested, the uniform national system will be a source of uncertainty and possibly also of high transaction costs.

Anderson effectively critiques the safe haven argument for maintaining a dual federal and state system of industrial regulations and tribunals. This is a very second best strategy with uncertainty, short sightedness and unnecessary changes with the political cycle.

To summarise, the choice in principle between a uniform national system of industrial relations over a system of competitive federalism involves a trade-off between the simplicity and lower transaction costs of a single system versus the dynamic efficiency gains of different States and the Australian Government competing for employers and employees with new and improved designs. In my assessment, to date we do not have convincing empirical evidence one way or the other, and this topic should be a high priority research topic. At the same time, as argued in Stewart and Anderson, there are many opportunities for the Australian and State Governments to simplify and streamline regulations of the labour market under the current federal structure.

General discussion

The general discussion for the labour market reform session focussed on four issues:

- the reasons for preferring a national system;
- whether new arrangements should allow for 'safe havens';
- whether the new regulatory arrangements could promote comparable outcomes across jurisdictions; and
- whether cooperation and mutual recognition would be a preferable approach to reform.

What are the reasons for preferring a national system?

One participant noted that there seemed to be agreement that the underlying objective of labour market reform should be about pursuing the 'best regulation'. There was also agreement by the two speakers that a national system could yield a better outcome than the current dual system. In this context, he then asked the speakers and discussant whether support for a national system was due to its inherent nature — it generates a good outcome — or because a national system would provide a vehicle by which we can get the best regulation?

Andrew Stewart responded that the inefficiencies and transaction costs arising from multiple sources of regulation in a small economy persuaded him that national regulation would be best. But this still leaves the issue of the most appropriate form of labour market regulation and, first and foremost, the need for regulations that are simple, understandable and make sense to employers and employees alike. While noting that the current system does not have these attributes, he also observed that national regulation can have a lot of flexibility and need not imply a 'one size fits all' approach.

Peter Anderson agreed that a national regime was preferable but for somewhat different reasons. He thought there was a strong 'in principle' argument for a national system based around the fact that Australia is a small economy and needs efficiencies of scale. However, he believed the most powerful reason for adopting a national system is that the current structure establishes jurisdictional obligations on

firms which are artificial and random, and beyond their control. In Anderson's view, there was no choice available to firms in the current system and it is wrong to suggest that the proposed changes to workplace relations would deny a choice that is currently available.

Another participant favoured a national system for industrial relations for much the same reason as border protection. In his view, just as Australia had done away with the States having import tariffs, we should do away with the idea of State labour market regulation.

John Freebairn, the discussant, argued that if we really knew and agreed what form labour market regulations should best take with respect to contracts between employers and employees, a single law would be straightforward. However, there are different views on the appropriate form that regulations should take — for example, whether contracts should be enterprise bargains or Australian Workplace Agreements, or whether there should be provision for penalty rates or not. In this context, he expressed concern about whether, at this time, the Australian Government could pick the 'right' regulation. Related to this, a 'second best' compromise could yield inferior outcomes to the current system. Accordingly, he felt that a system which allowed for experimentation and the exercise of choice would be preferable. However, he acknowledged that developing such a system would be a challenge.

Should any new arrangements allow for 'safe havens'?

One participant noted that some observers contend that state-based industrial relations systems can operate as a 'safe haven' for any employer from a federal system that may be judged inferior. The participant then asked the speakers whether we should be looking for arrangements that enable safe havens to operate and, if so, what would a national system provide?

In response, Peter Anderson indicated there were two main issues. First, are safe havens in principle a good thing? In his view, the answer depends on the circumstances and policy issue in question. Second, and more fundamentally, a safe haven is only an effective concept to the extent it has coverage. The fact that the Victorian Government referred its powers over industrial relations to the Australian Government in 1996 was heavily influenced by the fact that due to jurisdictional leakage the state system covered virtually no one at that time. As a result, there was no economic efficiency being delivered by the state industrial relations laws, because there was effectively no coverage other than for the corner fish and chip shop, and milk bar.

Andrew Stewart also thought there were two dimensions to the safe haven issue. The first was whether a safe haven is feasible. On this he agreed with the observations in Peter Anderson's paper that if the Australian Government did not want safe havens, then it would be impractical for them to operate. Second, would the Australian Government be better served, or would it better serve the interests of the Australian business community, by simply encompassing all corporations and taking them into the federal system whether they like it or not, or, alternatively, by giving them the choice? Currently, a trading corporation can choose whether it makes an agreement under federal or state laws (although a minority of businesses have this choice overborne by powerful unions). Related to this, Stewart observed that the model which the Productivity Commission canvassed in its review of national competition policy (PC 2005f) would allow businesses that could identify genuine gains from shifting into a national system to do so. Otherwise, they would be free to operate under the current dual system. It is intriguing, Stewart observed, that the Australian Government's instinct was not to support competition by leaving an element of choice.

Another participant agreed that an element of choice would make more sense and thought it interesting to go back to the principles outlined in the paper presented by Jonathan Pincus covering the circumstances in which allocating a function to the national government might be appropriate. In that participant's view, the only one that seemed to fit the labour market was where a diversity in rules or regulations is likely to give rise to high transaction costs with insufficient offsetting benefits. Accordingly, for some multi-state employers, a 'one size fits all' regulatory regime would undoubtedly be suitable. In this context, the lack of choice in the Australian Government's proposal is a curious feature. Another participant suggested that the ideal model would be one where the Australian Government put forward a system it thinks is best, and then invites businesses to 'opt in' only if they consider that it meets their needs.

Will new regulatory changes generate comparable outcomes across jurisdictions?

It was suggested by one participant that as a nation we accept and expect common outcomes across the board. The participant asked John Freebairn to what extent the new industrial relations changes were likely to generate comparable industrial and economic outcomes across regions or States, and to what extent should we be thinking about this issue?

John Freebairn saw this as an important question. From an economic perspective, a sensible case could be made for the minimum wage for indigenous people, for low-skilled people or for Tasmanians to be much lower than that for skilled people or

people working in Sydney. On the other hand, he suggested that it would be foolish to deny putting some weight on a case for uniformity along the lines of us all being Australians, suggesting that we should have a common minimum wage across the country. It is important, however, to take trade-offs into consideration. A minimum wage that was 'too high' would promote unemployment. There is often a failure to recognise — partly because of the uncertainty about the magnitude of the key demand elasticity — that having too high a minimum wage in particular areas and circumstances is actually adversely affecting some of the people we really want to assist. Freebairn concluded that it ultimately requires a political judgement.

Would cooperation and mutual recognition be a preferable approach to reform?

A participant asked the speakers whether mutual recognition between States, used in relation to product standards, could also be applied to industrial relations, in preference to the de facto separate industrial relations system being put forward by the Australian Government.

Andrew Stewart agreed there was a great deal that could be achieved by coordination and cooperation, and cited NCP as an illustration of positive cooperation. But he stated that in the area of labour market regulation, both the Keating and Howard Governments had been aggressive and adversarial, and this made it very difficult to develop a coordinated and cooperative way forward.

In contrast, Peter Anderson thought it was fanciful to imagine that in the industrial relations area, given the depth to which politics and policy is compromised and mixed, governments of different political persuasions could just sit down and reach an agreed position on the content of an integrated industrial relations system. He argued that the experience of the 1990s was that the cooperative approach — including attempts to have co-located tribunals, joint appointments between arbitrators and state and federal systems, and the sharing of some resources — only operated at the margin. Further, it basically stopped dead after a couple of years due to lack of political will on all sides.

PART D

FREIGHT TRANSPORT REFORM

8 Furthering significant freight transport reform in a federal system*

Rod Sims
Port Jackson Partners Limited

8.1 Summary — achieving significant freight transport reform

There seems wide agreement that there is much to be done in relation to transport reform, as the following quote shows.

> 'Indeed, in the Commission's view, recent initiatives have merely scratched the surface of opportunities for integrated reform in the freight transport sector. In particular, further pricing, access and regulatory reform is needed to achieve a freight transport system that encourages an efficient mix of transport modes and provides for the seamless movement of freight along the entire logistics chain'. (PC 2005f, p. 211).

This paper uses a review of past and future required changes in land transport freight policy to draw some lessons that can guide federal and state policy makers, as follows.

First, be very careful in declaring that the reform effort is complete. In large point this is what the Australian and State Governments did after the mid-1990s National Competition Policy (NCP) reforms.

Such early declarations, however, represent 'false summits'. The apparent end of one policy 'climb' simply exposes the extent of the next one. The full agenda is never visible at one point in time.

Road and rail freight reform provides an excellent example of these 'false summits'.

* This paper draws heavily on Bureau of Transport (BTE) and Bureau of Transport and Regional Economics (BTRE) publications. We do not wish to imply through this referencing that the Bureau endorses any of the conclusions reached, which are our own.

In the early-1990s reform agendas in both rail and road were key planks of NCP. The Australian Government and the States agreed to create National Rail from the various State freight entities, so ending the dysfunctional system of different rail freight operators in each State. They also agreed to take a national approach to road freight vehicle operation and registration, driver licensing and road user charging.

These reforms represented fundamental change. They achieved a national approach to both road and rail, so that there could be one freight market in Australia and not many.

Looking back, however, these changes only provided the platform for the reforms that are now required. We can now see that the changes in the early-1990s addressed each transport mode on its own, and left untouched the key issue of competitive neutrality between road and rail.

This lack of competitive neutrality is now causing major problems. Fixing it should be one of the most important infrastructure reforms on the Government's agenda. The benefits would range from significantly boosting Australia's GDP, to enhancing our physical environment, and to improving the safety record of land transport.

Second, significant change that requires close and continuing Australian Government and State cooperation requires Heads of Government involvement. When major organisations (for example, governments) need to work together to achieve reform those leading these organisations (the Prime Minister, Premiers) need to be aligned and to set the broad framework and objectives for the change agenda. They also need to monitor sufficiently closely the implementation to ensure it is successful.

In land transport, of course, intergovernmental issues dominate. There are, for example, shared roles under the Constitution in planning, funding and regulation and close coordination is both inevitable and desirable given the need to make the best use of our resources.

Third, significant problems can arise when different institutions regulate directly competing sectors. In land transport, the Australian Competition and Consumer Commission (ACCC) largely regulates rail user charges, while the National Transport Commission (NTC) sets road user charges.

Fourth, federal regulation requires strong institutions that can work freely within the legislative framework created for them. The current NTC is in many ways a facilitator as its recommendations require the agreement of a two-thirds majority of the Federal and State Transport Ministers.

Overall, freight transport reform requires another major level of impetus from the Council of Australian Governments (CoAG). With this impetus will come the need to reform many areas of policy, but also the need to rethink the role and mandate of some of the current regulatory institutions.

8.2 The growing importance of domestic freight transport to Australia

In a country as large as Australia, with its key population centres separated by large distances, it is vital that we have an efficient domestic freight system. This goes to the core of the economy's entire cost structure.

The then Bureau of Transport Economics (BTE) has estimated that the gross value added of logistic activities in Australia was equivalent to at least 9 per cent of GDP in 1999-2000 (BTE 2001). The freight component of logistics is estimated to be at least 40 per cent, with the other activities comprising storage, procurement, inventory management and packaging.

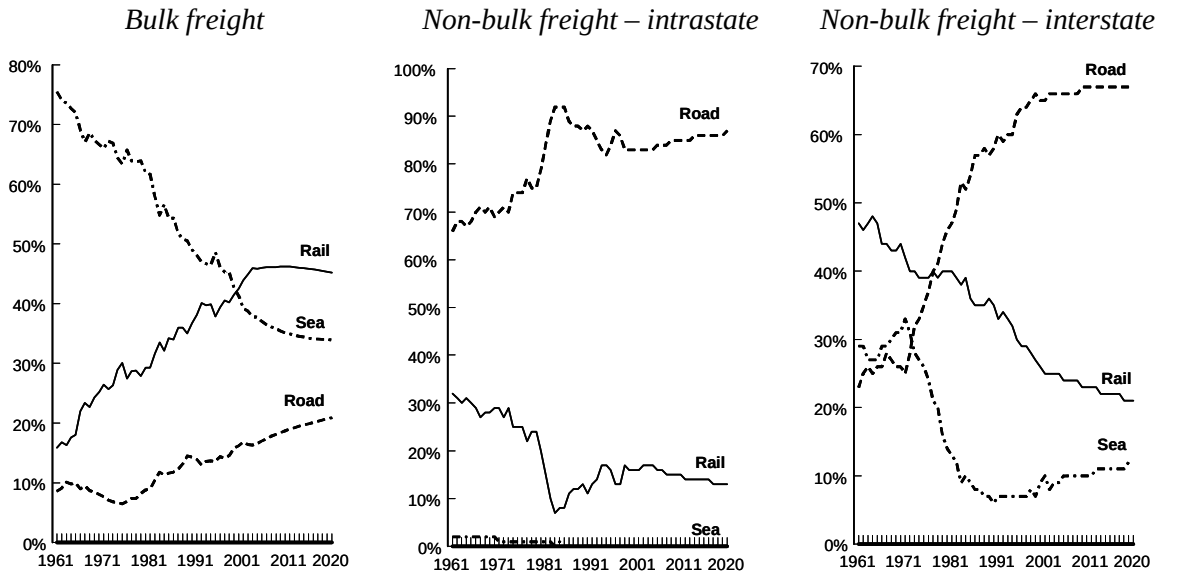
The BTE believes this approximate 3 to 4 per cent of GDP contribution by freight transport may well underestimate its economic contribution. In particular, the BTE's estimate of the contribution of freight transport does not take into account some transport activities that are undertaken in-house by firms primarily involved in other activities.

In addition, of course, the BTE says that the estimate of the contribution of freight to GDP does not take into account the support transport provides to all other economic activities as an enabler or facilitator (BTE 2001, pp. 32–3). To emphasise this point the Australian Government quotes research by the current Bureau of Transport and Regional Economics (BTRE) that estimates that a 1 per cent improvement in the efficiency of the transport sector (passenger and freight) would increase GDP by around $500 million in 2002 prices (DOTARS 2004, p. 1).

According to the BTRE the total freight task is forecast to almost double in the next 20 years. This expected growth, however, disguises some important underlying trends. While domestic non-urban bulk freight is expected to grow at 2.6 per cent per annum, non-bulk freight is expected to grow more quickly. Within non-bulk freight, intrastate non-bulk freight is forecast to grow at 3.2 per cent per annum, and interstate non-bulk at around 4.1 per cent, or considerably faster than GDP growth (BTRE unpublished).

Perhaps of more interest is what is happening to the modal shares of the various freight tasks. Figure 8.1 illustrates what has been the modal share trends for bulk freight, and for intrastate and interstate non-bulk freight.

Figure 8.1 **Modal shares by freight type**
Per cent share



Data sources: BTRE (unpublished); Port Jackson Partners Limited (PJPL) analysis.

Within bulk freight the main story is the decline in sea transport. In very broad terms, road and rail have kept their relativities one to the other.

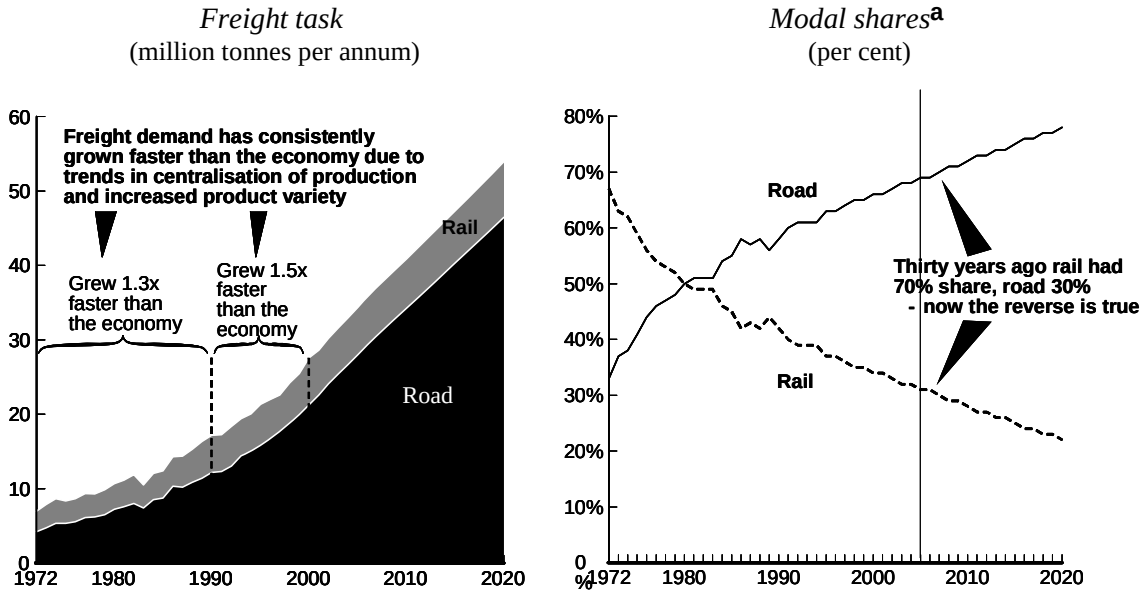
Within intrastate non-bulk freight road has always dominated, in large part because dispersed origins and destinations and shorter distances naturally favour road particularly, of course, in urban areas.

It is in interstate non-bulk freight, however, that the trends are most important. Road has dramatically grown its share at the expense of the other two modes, particularly rail. Given these trends, and the fact that the focus of this roundtable is on federal-state relations, the remainder of this paper will examine the interstate (indeed inter-capital) non-bulk land freight sector in more detail.

8.3 Trends in inter-capital freight land transport

In terms of the growth in inter-capital freight the BTRE believes that the next 20 years will resemble the last 30 years in that freight demand will continue to grow faster than the economy as a whole. This is shown in figure 8.2. While this trend cannot go on forever it reflects the increasing centralisation of production sources and a desire by consumers for increased product variety.

Figure 8.2 **Trends in inter-capital freight land transport**



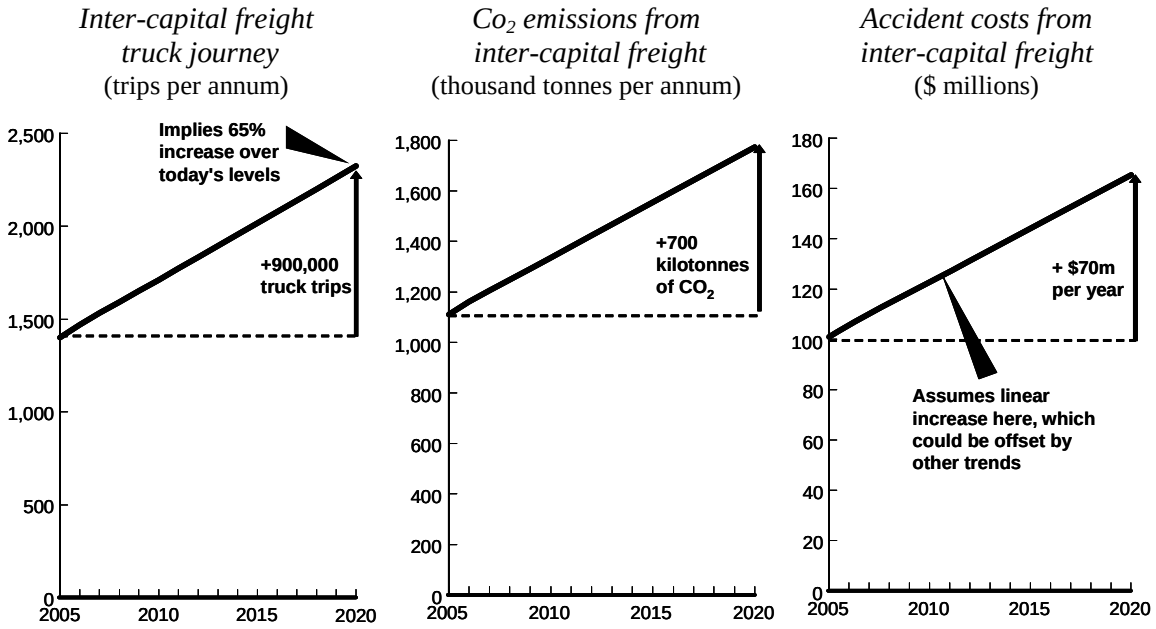
a Model shares by net tonne kilometres between road and rail only.

Data sources: BTRE (2003); Gargett and Cosgrove (2004).

The other major trend in inter-capital freight has already been mentioned. While 30 years ago rail held a 70 per cent share of inter-capital land freight by net tonne kilometres, with road having a 30 per cent share, today this position is reversed. As shown in figure 8.2, the BTRE predicts this trend to continue. These projections are, of course, based on the current policy settings.

This forecast growth in road freight will have important consequences. It will, for example, increase the number of trucks on our inter-capital roads by 65 per cent over the next 15 years, assuming some continuing trend in carrying freight more by articulated rather than rigid trucks (the figure is 75 per cent with the current truck configuration, loads and utilisation). As shown in figure 8.3 this will bring associated environmental and safety issues.

Figure 8.3 **Impact of growth in freight on road traffic and CO_2 emissions — business as usual**



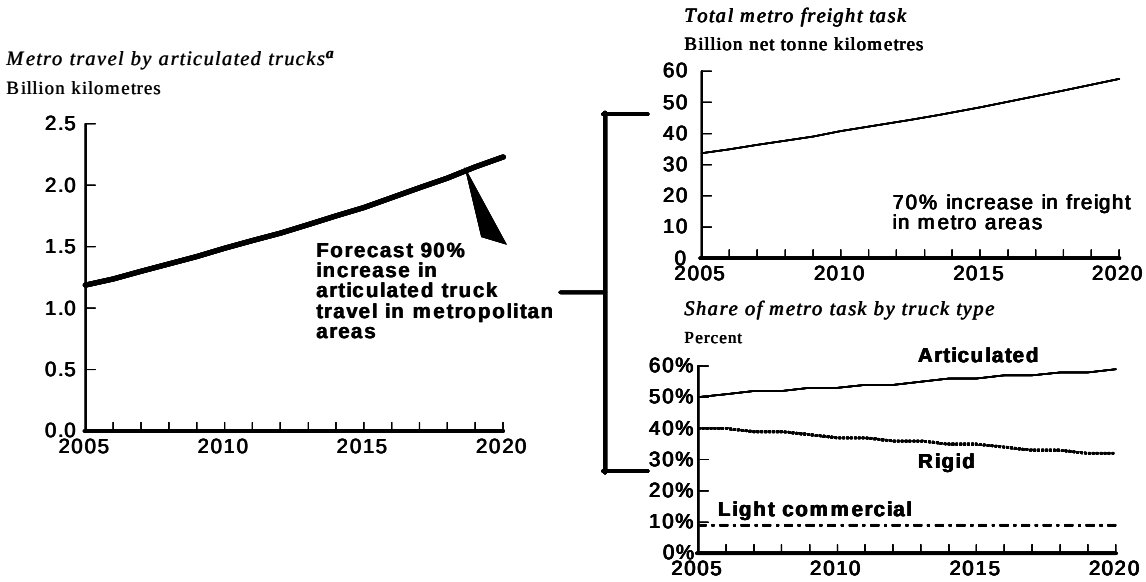
Data source: BTRE (various sources).

The effect on our cities is forecast to be even larger. As shown in figure 8.4 the BTRE expects a 90 per cent increase in articulated truck travel in metropolitan areas over the next 15 years, albeit off a low base. This is due to the rising freight task and the growing share of road freight taken by articulated rather than rigid or other trucks.

This rapid growth in road transport under the current policy settings will also drive a much larger expenditure on roads than would otherwise be required. This will occur because more road capacity will be needed and because stronger and so more expensive pavements are required to withstand the additional loads being carried. This can be seen from figure 8.5 which shows in a conceptual sense, using BTRE methodology, how a higher proportion of heavy vehicle traffic affects the timing of road construction. With a 10 per cent share of traffic comprising heavy vehicles a six lane divided road may not be needed for 37 years, whereas with a 30 per cent share of traffic it would be required within 20 years.

At the same time as the above modal shift is occurring our rail system is in disrepair in many places or bottlenecked in key areas. In an immediate sense this can be seen in the speed restrictions placed on parts of rail track, but in a more fundamental sense it can be seen in poor track configuration.

Figure 8.4 **Projections of metropolitan freight traffic growth**

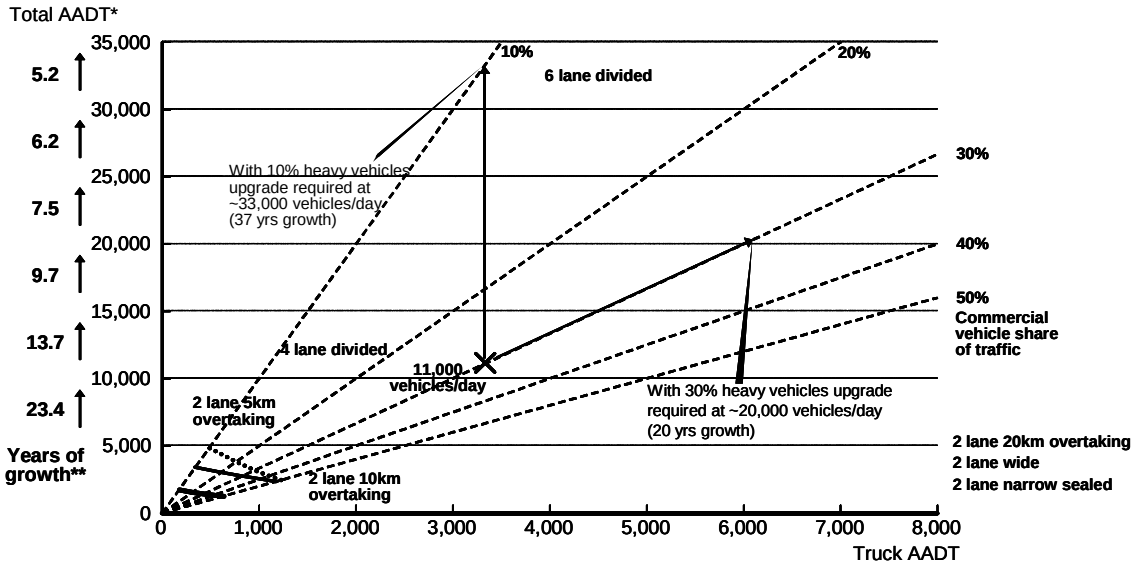


a Assumes average load of approximately 15 tonnes.

Data source: Gargett and Cosgrove (2004).

Indeed, when the key comparative indicators are examined it can be seen that rail is losing share largely because of very poor transit times, reliability and the extent to which rail offers services at times the market wants.

Figure 8.5 **Upgrade traffic levels for various car/truck mixes**

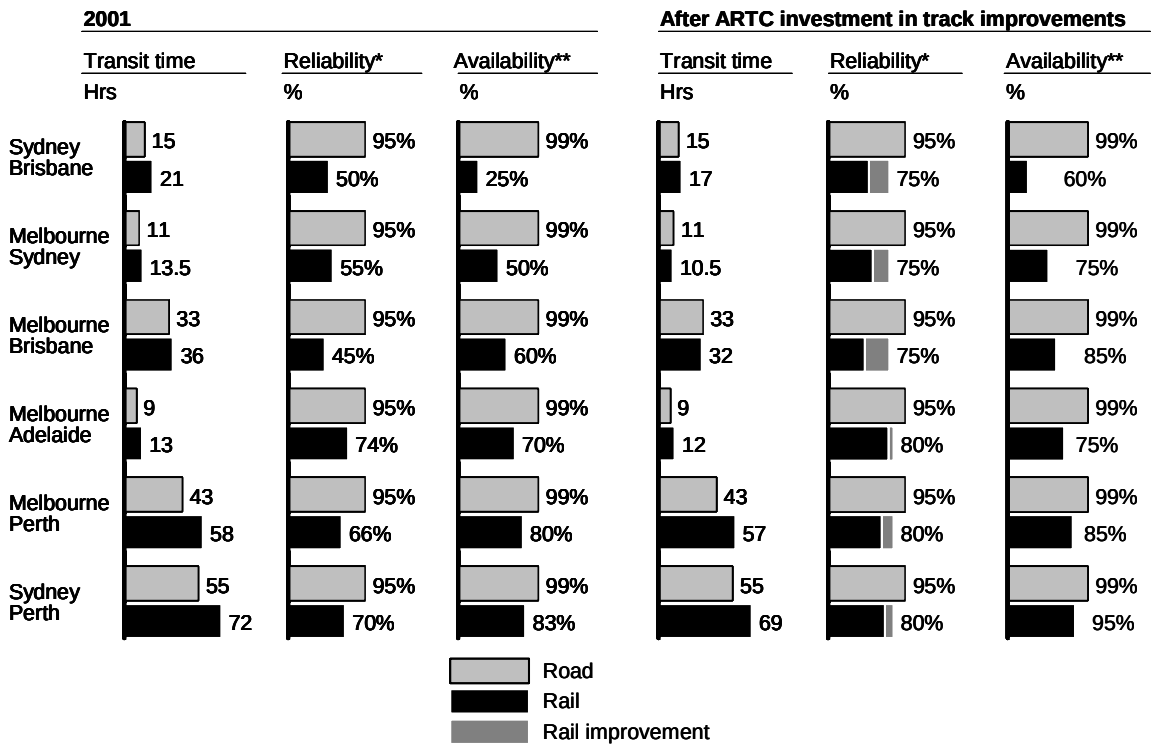


* Annual average daily traffic (AADT). ** 3 per cent annual growth rate assumed.

Data sources: BTRE (1997); PJPL (analysis).

On the north-south routes rail's reliability and availability has recently only been about half that of road. This is shown in figure 8.6 which also shows a better relative performance by rail on the east-west routes. It is no surprise then to notice that rail's north-south modal share is 16 per cent, while it is around 60 per cent on the east-west routes.[1] Note that the performance of the north-south track will improve with the planned investment by the Australian Rail Track Corporation (ARTC), but it will still remain well below that of road.

Figure 8.6 **Key reliability and availability service characteristics**



* Per cent of services arriving within 15 minutes of scheduled time. ** Extent to which mode offers services at time the market demands.

Data sources: Booz Allen and Hamilton (2001); PJPL (analysis).

It would not be a cause for concern if these trends and projections reflected the underlying economics of road and rail transport. The facts are, however, that they do not.

Indeed, rail is the lowest cost mode of transport on all inter-capital corridors, particularly east-west but also north-south, when 'efficient' costs are used (see below). This conclusion came from a report prepared by Port Jackson Partners

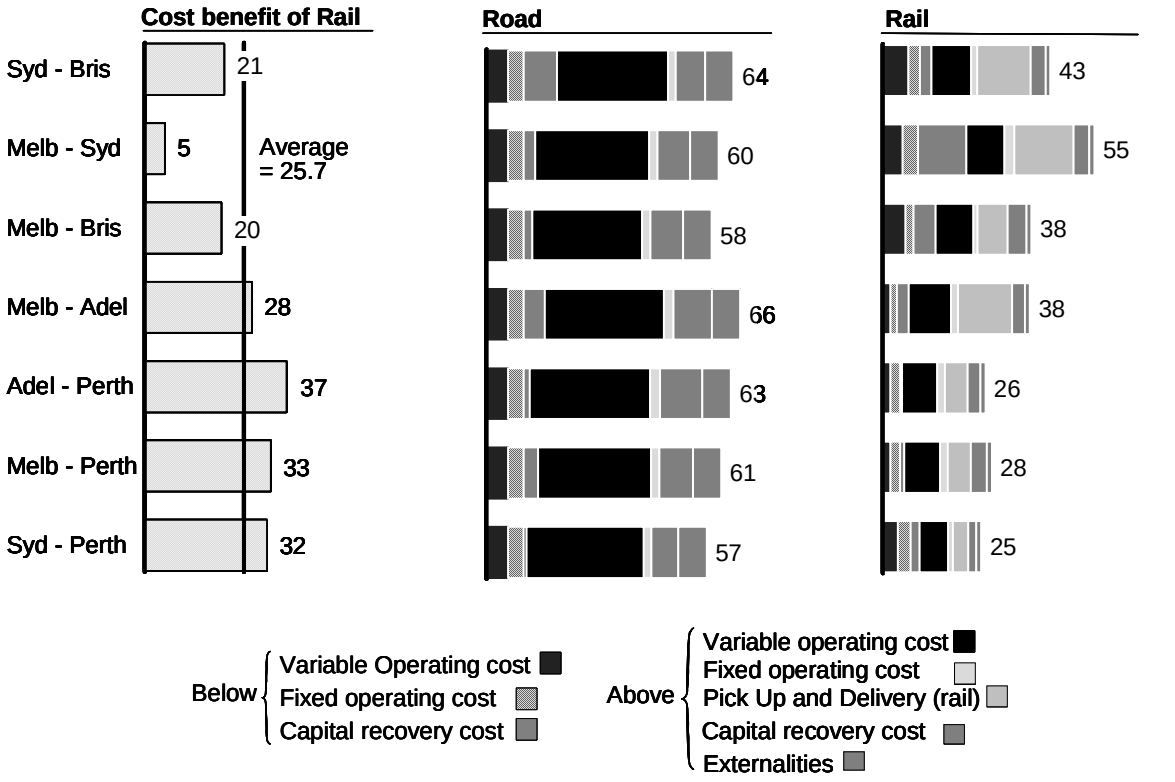
[1] It is important, of course, to note that the east-west routes are longer which allow rail's low line haul unit costs an even better chance of offsetting rail's higher terminal unit costs.

Limited (PJPL) for the Australasian Railway Association (ARA) titled 'The Future for Freight' (PJPL 2005). When the truck and train capital and operating cost picture is combined with the road and track operating and capital cost picture, and when allowance is made for rail's lower externality (mainly accident) costs, rail appears to have a material cost advantage over road. This is shown in figure 8.7.

It is important to note two key features of the analysis shown in figure 8.7. First, it is based on the through chain costs of providing the roads and railways, not the current access charges, which do not always reflect the true underlying costs as will be seen in the next section. Second, it assumes that NSW track infrastructure costs would be reduced to 'efficient' levels to meet the public commitment made by the new track owner, the ARTC, to halve the current operating cost levels.

Figure 8.7 **Total cost comparison**

$ per '000 net tonne kilometres



Key assumptions:

- Based on through chain costs, not current access charges
- Forward looking: no capital charge for sunk capital
- NSW track costs reduced to efficient levels
- Road operating costs modelled on B-doubles

Data source: PJPL (2005).

Why is the lowest cost mode of transport mode moving so little of our inter-capital freight?

The answer can be found in poor public transport policy.

Before turning to the current public policy problems in land transport freight, however, it is useful to outline briefly some of the recent history of public policy change and the importance in this of the division of powers between governments and the role of intergovernmental collaboration in developing and implementing reforms.

8.4 Some recent land transport policy changes and the importance of federal-state cooperation

Prior to the early-1990s

Prior to the early-1990s land transport in Australia was state based. Indeed, in terms of land transport, Australia resembled six or seven different countries rather than one.

In rail freight, each State (except South Australia) had their own rail freight company which owned both trains and tracks. Moving freight interstate required the cooperation of various state-based entities, so accountability for successful freight delivery was never clear. These state-based rail freight entities served the intra and interstate markets and were all loss making.

In relation to road freight each State had very different road user charging and regulation. This made interstate road transport costly and more complex. It saw trucks having to configure their vehicles to suit the differing regulations of all States.

Given the above, the Australian land transport freight market was more fragmented than the equivalent market in Europe.

Many attempts at major change were made prior to the early-1990s, without success, through the regular meetings of Transport Ministers and officials. Continuing attempts, for example, were made to make transport regulation more uniform, but this progress was modest. This was because all jurisdictions had to agree and all had an equal voice. While the Australian Government attempted to play an influential role it also had to tread very carefully around what were strong ‘States rights’ issues.

The early-1990s 'cooperative federalism' and National Competition Policy

It took the early-1990s period of 'cooperative federalism' that was initiated by the then Prime Minister Bob Hawke to deliver significant change. After he won his fourth election in 1990 Bob Hawke initiated a major agenda to improve the way Australia's federal system worked. He launched major change in most policy areas including infrastructure and social policy. He was strongly supported by the then Premiers of NSW (Nick Greiner), Queensland (Wayne Goss) and Western Australia (Carmen Lawrence) in particular.

This period of 'cooperative federalism' saw federal-state committees of officials formed to tackle many specific issues. What was different is that they had a strong Department of Prime Minister and Cabinet (at the level) and Premiers Department (at the State level) representation, and a clear mandate for change from the newly formed CoAG which comprised the Prime Minister and all Premiers.

The changes agreed were dramatic.

In rail, the States agreed to cease their involvement in interstate freight and to contribute their relevant assets to a newly formed National Rail Corporation. In future, interstate rail could be undertaken through one fully accountable entity. Over a number of years it eventually became profitable.

In road, a national system of user charging and road regulation was agreed. It was to be implemented through a new federal-state entity, the National Road Transport Commission (NRTC).

The agreed changes were aimed at a national approach to both road and rail, so that there could be one freight market in Australia and not many as had existed since federation and before.

The various agreements were incorporated into the NCP agreements at least at a high level in the mid-1990s. These agreements followed the Review of Competition Policy by Fred Hilmer. They saw the agreed measures documented so that implementation could be monitored by the National Competition Council (NCC).

It is very important to note that the Productivity Commission believes that the NCP '… Implementation Agreement provided only very general guidance to governments on their reform obligations in road transport and this resulted in implementation delays' (PC 2005f, p. 419). In addition, the Commission refers to difficulties in achieving and then implementing appropriate national regulation, and that in 'six NRTC reform initiatives — covering mass limits, speeding, truck

trailers, axle mass spacing, noise and compliance and enforcement arrangements — they have not been monitored or assessed by the NCC' (PC 2005f, p. 419).

The Productivity Commission goes on to mention:

> … widespread claims from the industry of inconsistencies and shortcomings in the implementation process. In responding to these claims the NCC … stated that the reform agenda to 2001 had not comprised all of the initiatives needed to develop a nationally consistent regulatory regime. (PC 2005f, p. 420).

Policy changes since the mid-1990s

There have, of course, been many policy changes since the changes described above in the early to mid-1990s. While extremely important, with one exception they largely represent flow-on changes from what has been outlined above.

The main flow-on changes can be summarised as follows.

- The Australian Government formed the Australian Rail Tack Corporation (ARTC) off the back of its ownership of the South Australian rail track and the Western Australian track east of Kalgoorlie. The Australian Government recently negotiated lease access to the Victorian and NSW interstate tracks to create a one-stop-shop for rail track access from Perth to Brisbane.
- Three years ago the Australian Government, NSW and Victoria sold National Rail to the privately owned Pacific National. This meant that the majority of interstate non-bulk freight was now carried by the private sector.
- In January 2004, the Australian Government and the States agreed to replace the NRTC with a new NTC which will consider the reform of both road and now rail regulation.
- Continuing progress has been made by Transport Ministers to create more national transport regulation in both road and rail. Progress has been steady but slow.

Perhaps the major change in recent years has been the Australian Government's AusLink policy (DOTARS 2004). The plan involves, in essence, a major change to how road and rail investment is planned and funded.

Before AusLink the Australian Government funded the National Highway System and targeted other roads, and the States and local government funded the remaining roads in their jurisdictions. In addition, road and rail funding were considered separately, as on occasion were issues to do with port development and the transport links to them. This saw a number of problems:

- road investment decisions were influenced disproportionately by the source of funding, rather than need;
- corridor strategies were fragmented; and
- cross-mode solutions were not sufficiently considered.

In the words of the Australian Government:

> 'The current framework for land transport infrastructure planning, decision-making and funding in Australia is fragmented, short term, and unable to deal adequately with the emerging need for a substantial increase in infrastructure spending on the transport system'. (DOTARS 2004)[2]

Under its AusLink initiative the Australian Government has proposed the following.

- It will put its funding through AusLink rather than through its previous National Highways and other specific land transport funding programs.
- A National Network of important road and rail infrastructure links has been defined and these are to be funded by the Australian Government and the States together based on an integrated corridor approach to funding.
- Funding is to be neutral between road and rail and so based on where the largest benefits are to be found.
- Future funding is to be based on a 20 year planning horizon facilitated by the development of corridor strategies.

Completing the current agenda

While the recent changes seem to address many issues, there is in fact much more to be done to complete the current agenda.

First, in relation to AusLink, there has been slow progress so far in relation to joint federal and state transport planning in general and the development of the required corridor strategies in particular. A major push seems required to turn the excellent theory into practice.

Second, in relation to road regulation, the NRTC, and now the NTC, is more of a facilitator than a regulator. In the end a majority of the nine governments need to agree to most proposed changes, and there is then little ability to enforce agreements. For example, there was agreement among Ministers to uniform heavy vehicle mass limits but not all States have implemented them. It is still the case today that there is no common heavy vehicle mass limit across Australia. A vehicle

[2] These statements, of course, refer to the environment prior to the AusLink reforms.

with the maximum allowable mass in Victoria, for example, cannot travel into NSW.

Third, in the case of rail, there is an even larger need for uniform regulation. Australia has, for example, many differing State requirements for train radios, and numerous rail safety regulatory and investigatory bodies.

There is, therefore, much to be done to complete the current agenda. There is also a need, however, to embark on a new agenda as discussed in the next section.

8.5 Creating competitive neutrality between road and rail

The reforms of the early to mid-1990s represented fundamental change. They made it possible to envisage a national freight market in Australia. While as the above comments show there are still many steps to be taken to create a national market, at least some firm foundations have been laid.

Those foundations allow us to consider the next round of reforms that are needed in land transport freight. The reform steps taken so far are mainly about seeking to improve each transport mode on its own. They leave largely untouched the key issue of competitive neutrality between road and rail.

Indeed, an analysis of the inter-capital freight market today leads to the following important conclusions:

- there are at least three major public policy problems in terms of how current policies for both road and rail work in combination; and
- the effect of this poor public policy is to distort significantly the price/service offering of rail compared to road to the detriment of the efficiency of our inter-capital freight.

We shall address each point in turn.

The three major public policy problems

These problems can be summarised as follows.

- The heaviest, longest travelling trucks are undercharged for their road use.
- While rail user charges are set after allowing for a return on past sunk capital, road user charges are not.

- Different assessment criteria are used when judging rail and road infrastructure investment.

It is important to explain each of these points in some detail.

The heaviest, longest travelling trucks are undercharged for their road use

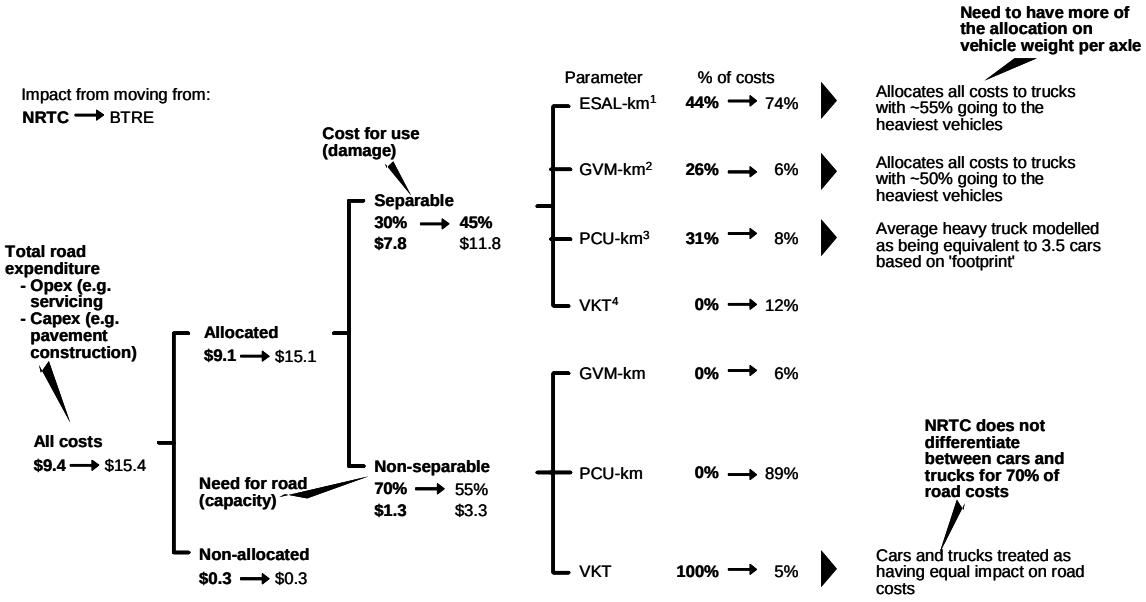
This first issue can be simply demonstrated.

In Australia, all road expenditure is allocated to cars and trucks according to the expenditure caused by their usage as determined by the NRTC (now the NTC). The expenditure allocated to trucks is recovered by registration and fuel charges. The problems with this allocation system cause much of the undercharging.

The problems with the current allocation system are perhaps best shown by a comparison between the NRTC's approach and that taken by the BTRE. The two approaches are contrasted in figure 8.8.

Figure 8.8 **Comparison of NRTC and BTRE heavy vehicle road cost allocations**

\$ per '000 net tonne kilometres



1 ESAL = Equivalent Standard Axles Loads
2 GVM = Gross Vehicle Mass - passenger vehicles are given a value of 0.0
3 PCU = Passenger Car Units - a measure of the space taken up by a vehicle on the road
4 VKT = Vehicle Kilometres Travelled

Data sources: BTRE (1999); NRTC (1998); PJPL (2005).

There are several important differences in the two approaches.

As one example, the current allocation regime sees 70 per cent of all costs labelled as 'non-separable' and so not attributed to any particular vehicle. Non-separable costs are to cover the underlying need for the road while separable costs cover the damage caused by an individual vehicle. These non-separable costs are then allocated by vehicle kilometres travelled, so that a truck used for inter-capital haulage is treated the same as a car. Yet such a truck should be seen as 3.5 times a car based on its 'footprint', or larger occupation of road space.

As another example, the latest research on international approaches to cost allocation would see separable costs higher than 30 per cent, and pavement damage more dependent on vehicle weight per axle than is currently assumed by the Australian allocation methodology (PJPL 2005, ch. 3.2, appendix 2).

Australia's cost allocation method is out of step because the aim in the early-1990s was to gain a uniform charging system across States and to charge trucks more of the costs they impose in fairness to car owners. It was sufficient to take a limited step, albeit a move in the right direction. A desire to achieve a level playing field between road and rail freight, however, requires a more accurate method of cost allocation which incorporates some of the changes just mentioned.

Another problem is widely acknowledged. It is that the current charging mechanisms used in Australia see charges decline with mass and distance. This favours the heavier, longer travelling trucks over other trucks, yet it is the former that compete with rail on the inter-capital corridors. Both the NRTC and the BTRE seem to agree on this:

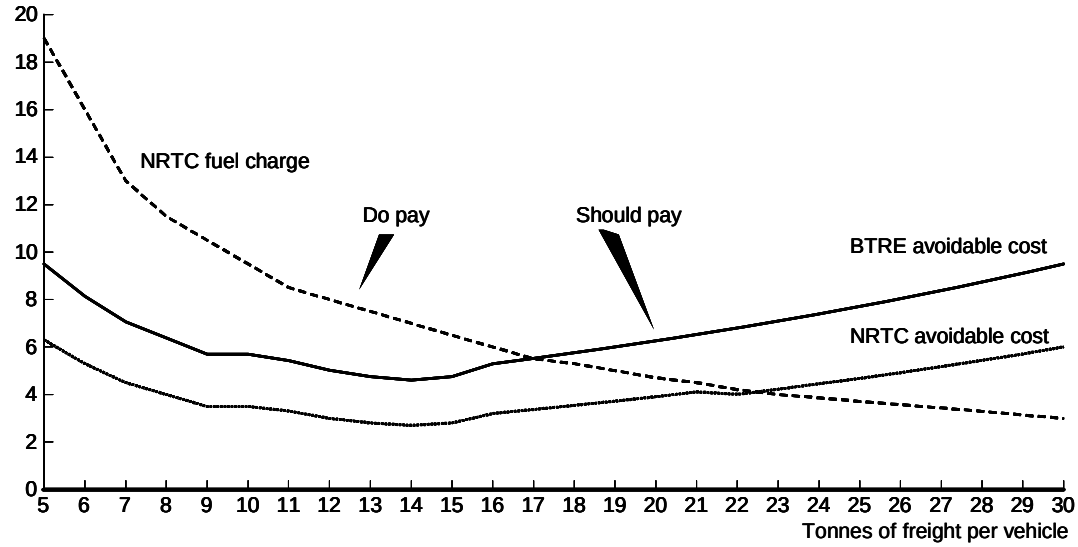
> For road transport there is a fixed annual registration charge and a variable fuel charge … this charging structure does not closely match the amount paid to the individual vehicle's marginal cost of road use. Highly utilised vehicles and those with good fuel consumption rates pay too little. (NRTC 2003, p. 56)

> BTE results indicate that heavily laden vehicles are currently undercharged, lightly laden vehicles are overcharged and the current imputed fuel excise credit does not recover the road wear costs caused by heavy vehicles. Some form of mass distance charge would be more efficient. (BTRE 1999, p. 36)

The effect of this has been illustrated by the BTRE. This is shown in figure 8.9.

Figure 8.9 **Avoidable[a] road wear costs and charges — six axle articulated truck**

$ per '000 net tonne kilometres



* Avoidable costs are those resulting directly from traffic interactions with the highway - predominantly wear and tear on the road surface

Data sources: BTRE (1999); PJPL (2005).

Currently several European countries are progressively introducing mass distance charging. By charging based on mass and distance they are directly addressing this problem.

It is, of course, important to note that fundamental reform in this whole area must involve intergovernment cooperation since the various charging structures have important but different implications for federal-state revenues.

While rail user charges are set after allowing for a return on past sunk capital, road user charges are not

The second public policy problem is that while rail user charges are set after allowing for a return on past sunk capital, road user charges have to cover each year's current investment which leads to quite different results. The different policies are summarised in box 8.1. With the current road access charging regime which commenced in the early-1990s there is no allowable return in road user charges on the initial sunk investment. Rail's access prices cover a return on all past investments that are revalued every five years to achieve a Depreciated Optimised Replacement Cost (DORC) valuation.

Box 8.1 **Access regime comparison — road versus rail**

Road

'Instead of separately costing past efforts to construct roads and future maintenance requirements, it is assumed that current expenditure provides a reasonable proxy for annualised costs of providing and maintaining roads for the current vehicle fleet.

This approach is known as the PAYGO, or pay-as-you-go, approach to setting cost-allocation targets'. (NRTC 1998)

Rail (ARTC example)

'The Ceiling Limit means the Charges which, if applied to all operators of a Segment or a group of Segments would generate revenue for ARTC sufficient to cover the Economic Cost of that Segment or group of Segments'.

Economic Costs include:

- Segment specific costs and an allocation of non-segment specific costs;
- Depreciation of segment specific and non-specific assets; and

A return on segment specific and non-specific assets based on DORC (revalued every five years). (ARTC 2002)

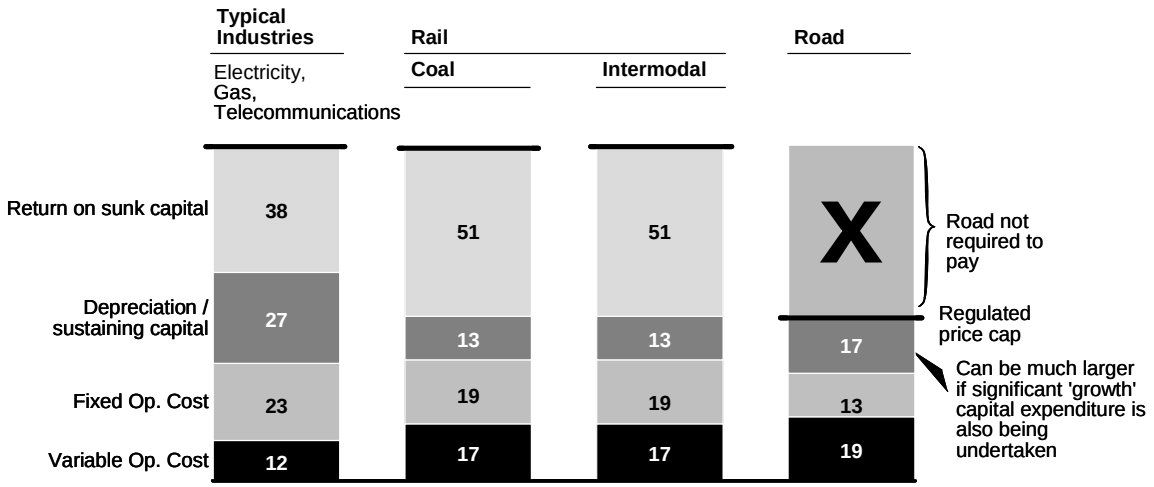
Source: PJPL (2005).

The effect is that rail access charges can be set to recover more than road access charges, although much depends on the relative levels of 'growth' and 'replacement' expenditure. While figure 8.10 illustrates these differences the obvious question is why would two competing industries be subjected to different access charging principles?

The setting of road access charges is unique: all other infrastructure user charges are set allowing a return on past investment. The road user charging approach was, of course, put in place prior to the formulation of access regimes for all other infrastructure. Again, any change to road user charging approaches will require federal-state agreement.

Figure 8.10 **Comparison of access pricing policy regimes[a]**

Per cent of total



a Estimate for *Typical Industries* taken from the IPART (1999, p. 77); Coal assumed to have same distribution by cost component as Intermodal; Road sunk capital assumed to be same proportion of total access fee as for Intermodal.

Data source: PJPL (2005).

Different assessment criteria are used when judging rail and road infrastructure investment

The third public policy problem is that different assessment criteria are used when judging rail and road infrastructure investment. Rail projects are usually assessed on financial criteria, whereas road investment is assessed using economic cost benefit criteria. One key difference, therefore, is that rail investment must be justified by considering only the benefits to the investor, whereas road investment can be justified by considering wider benefits such as reduced travel time and traffic accidents. The Australian Government has recently acknowledged the importance of this difference, as shown in box 8.2, as has the Australian Transport Council (ATC 2004) in its 'National Guidelines for Transport System Management in Australia'.

Box 8.2 **Road and rail have been subject to different investment criteria**

The AusLink (DOTARS 2002, p. 27) raised the issue of:

> '…different assessment criteria for road and rail infrastructure investment.
>
> Rail infrastructure projects are commonly appraised on financial rather than economic cost-benefit criteria. Financial analysis presents higher hurdles than economic analysis by excluding benefits for organisations or groups and only considering those for the investor. Financial analysis also has to take account of corporate taxation and does not include consumers' surplus gains, which can make an important difference for large lumpy investments.'

... and the subsequent White Paper (DOTARS 2004, p. 13) recognised that:

> 'Rail infrastructure investment has been largely ad hoc.
>
> The arrangements for the planning and funding of rail network infrastructure reflect, in large part, the origin of the rail network in separate State-based rail systems. These have been independently run and managed with funding decisions historically driven by local needs.
>
> *The overall amount of funding available for rail infrastructure has also been severely limited*…'

The effect, as recently also acknowledged by the Australian Government, is that … 'the overall amount of funding available for rail infrastructure has also been severely limited' (DOTARS 2004, ch. 1, p. 13).

The effect of this poor public policy

The effects of the above three public policy problems are profound. They go to the heart of the competitive dynamics between road and rail freight on the inter-capital corridors.

The most obvious effect is that day-to-day choices between road and rail freight are distorted, as the road and rail freight rate differences do not reflect the underlying cost differences.

Equally pervasive, artificially low road user charges limit what rail track owners can charge, because of the direct road and rail competition. This makes rail track investment financially unattractive, and so reduces track investment, which means poor rail service levels as the track is often of poor standard.

Further aggravating relative investment levels are the different assessment criteria. If all the externality benefits and costs of both road and rail were factored into investment decisions this would favour rail investment. Rail transport causes fewer

environmental and safety problems than road transport (PJPL 2005, ch. 3, appendix 2).

The effect of this poor transport public policy is, therefore, to distort significantly the price/service offering of rail compared to road. Rail is losing market share for the wrong reasons.

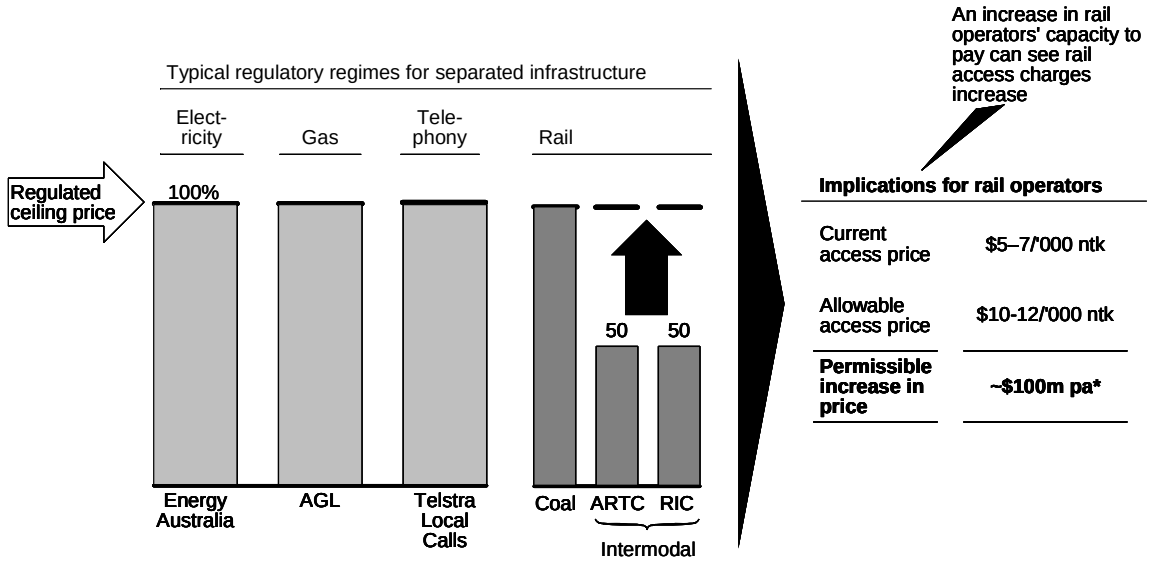
A coming, even deeper problem

Access to inter-capital rail freight is priced at levels allowed by competition from road. Given all of the above points, such as the low pricing for inter-capital road access charges and the different access charging regimes, on inter-capital routes rail access fees never reach ceiling levels.

This creates a major problem.

Under the current regulatory conditions the below rail access providers could increase access fees significantly over time. Their only limit in doing so is the current low profitability of rail operators. Access pricing has been held down by the ARTC to assist the rail industry to gain market share. As shown by figure 8.11 the present rail access prices can, in the ARTC's jurisdiction, be more than doubled within the limits established in the ACCC Access Undertaking.

Figure 8.11 **Rail's regulatory regime allows for large access price increases**
Per cent of total defined costs



* Calculated as $6/'000ntk increase across current intermodal rail task of ~16bn ntk.

Data source: PJPL (2005).

This ability to increase user charges with the capacity of operators to pay is unique to rail. All other infrastructure with access regimes sees user charges set at the regulated ceiling level. This does not occur in rail because user charges are limited by direct competition with road.

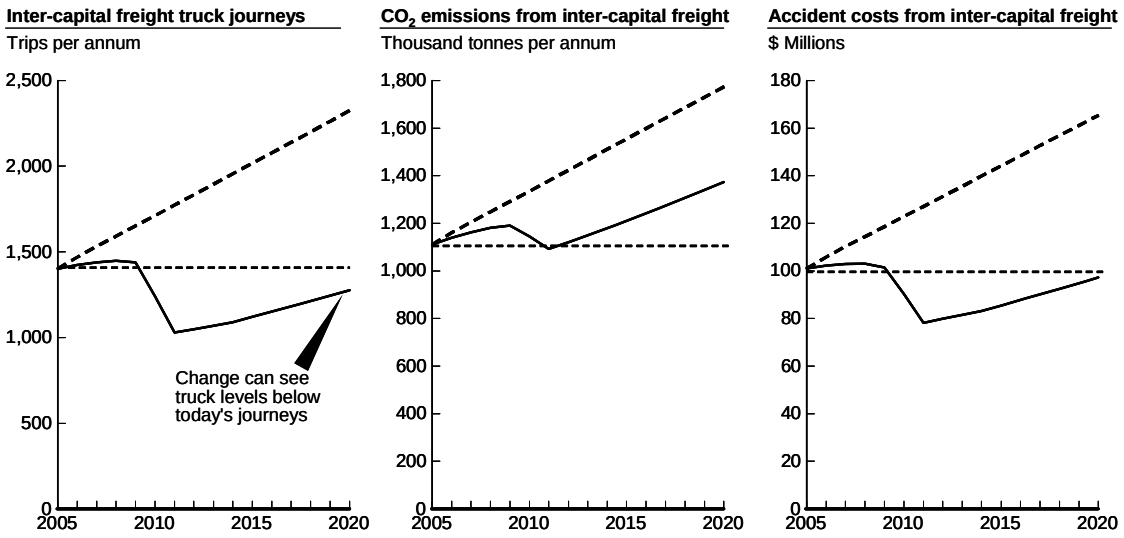
This issue has the potential to limit severely the level of investment by commercial rail operators. The current rail access regime can, in its effect, extract all additional profit from new rail investment and leave rail operators with profits at stay-in-business levels.

Whatever the stance or intentions of track owners, the train operators will not be able to risk large investments and take business risks in freight markets while access fees can rise to take the incremental profits they create from improved service or increased investment.

Some implications from significant land transport reform

With significant reform it is likely that rail can dramatically increase its share of intermodal freight. Rail may, for example, be able to increase its north-south market share to the levels currently achieved on the east-west routes, or to 60 per cent. As this increase would come on heavily trafficked routes the effects could be large, as shown in figure 8.12.

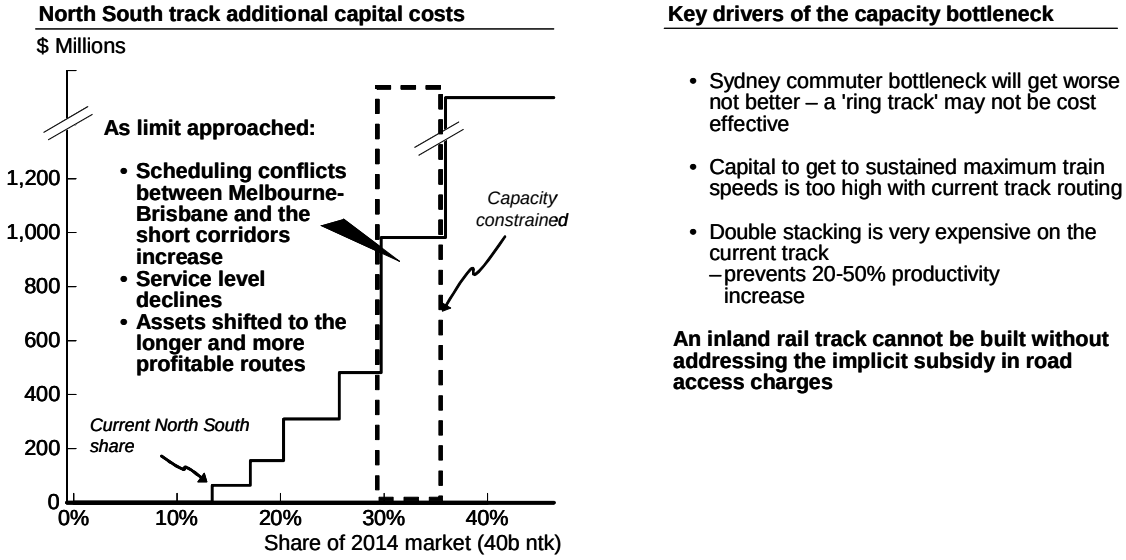
Figure 8.12 **Impact of growth in freight on road traffic and CO_2 emissions — unconstrained rail scenario**



Data sources: BTRE (1999); BTRE (2003); PJPL (analysis); Affleck Consulting (2002).

The problem with any reform program, however, is that the north-south coastal track will naturally bottleneck at around 30–40 per cent modal share by 2010. This is illustrated in figure 8.13.

Figure 8.13 **Costs of increased capacity and forecast rail share with existing track**



Data sources: Booz Allen & Hamilton (2001); BTRE (2003); DOTARS (2002, 2004); PJPL analysis.

The Australian Government's AusLink program may help achieve the capacity for rail to move to a 30 per cent modal share on the north-south corridor but there will still be inefficiencies. To increase rail's share significantly requires an inland rail route that will take many years to build, and significant changes in government policy to bring it about.

8.6 Achieving further significant reform in our federal system

Overall, the time now seems right for significant land transport reform. The various pre-conditions seem to be in place.

A well structured and coordinated process of change between the Australian and State Governments is required. This is clear from looking at how past major transport reforms have been achieved, and from examining the required future reform agenda. The reform agenda also needs to be broad and inter-modal.

Indeed, the required changes include the need for cost reflective user charges for heavy road vehicles, the introduction of mass distance charging, factoring externalities into pricing and therefore investment, aligning the framework for access regimes and providing certainty of access fee levels to above rail operators.

Two key steps are needed to both deliver the new reforms that were discussed in Section 4 and to complete the current reforms described in Section 3.

The first step is for CoAG to re-engage in transport reform. Not only is another reform 'push' required, but CoAG needs a continuing involvement to ensure the required changes are followed through.

CoAG needs to re-engage because transport reform involves continuing federal-state issues, yet when First Ministers are not involved momentum can be lost. This is because decisions then get put into the hands of those who can lose some of their influence if change occurs. Put another way, reform will only occur when the bigger picture of improved national productivity is uppermost in the consideration of policy makers.

In the early to mid-1990s First Ministers did not need to get involved in the detail of change. All that was required was that they set higher level reform objectives and signalled that they would monitor progress towards them.

When important policy issues involve continuing federal-state cooperation, progress will only occur if the government leaders set the overall direction and attach importance to it.

This should be no surprise. In the private sector no alliance between two companies would work without the respective CEOs enthusiastically supporting it on a continuing basis through the main change process. Governments are no different to other organisations.

The second required step is for strong national institutions.

In general terms, there is a need for some broad national reform monitoring body that reports to CoAG on whether or not its decisions are being followed through and which plays a role similar to that played now by the NCC.

In particular, a national freight market may require at least three specific institutions.

- The NTC could become a more independent transport regulator that has the power to set and monitor national transport regulation. Ministers would establish an Act, and be free to change it, to provide the overall framework. Within this,

however, the NTC should be able to operate freely and be accountable for its decisions.

- The ACCC could become responsible for road user charges as well as its current role in setting rail user charges for freight operators. It should also be responsible for administering all access regimes for freight operations including those covering purely intrastate freight. The ACCC can then align the rail and road user charging methodologies and ensure that competitive neutrality exists.
- A National Transport Safety body should be formed so that a uniform approach is taken in this key area, and so that the lessons learnt in one area can be passed to another.

To make our federal system work, therefore, we need a continuing mechanism to allow First Ministers to set and monitor the policy direction, key objectives and outcomes; and we need strong national institutions.

It would be surprising if other sectors that saw a large and continuing set of federal-state issues did not require the same two key steps to be taken.

9 Regulatory reform in land transport

Tony Wilson and Barry Moore
National Transport Commission

9.1 Introduction

The National Transport Commission (NTC), including its predecessor, the National Road Transport Commission (NRTC), is a unique organisation in the Australian context because it commenced as an experiment in cooperative federalism but still exists after nearly 14 years at the cutting edge of reform. Such experiments usually wind up in a relatively short time, having either completed the reform process or demonstrated an inability to do so.

The purpose of this paper is to describe the unique features of the NRTC/NTC model in the Australian context, to assess the success of the model and to suggest possible improvements which would allow the model to contribute more effectively to the next phase of land transport reform.

Whilst the NTC mandate covers road, rail and intermodal transport, the focus of this paper is largely on road as it is this mode which has been subject to a national approach for long enough to enable worthwhile assessment.

9.2 Institutional environment

Recent reforms in the regulation of land transport have occurred in an environment in which regulation of road and rail transport is primarily the province of the States, and the powers of the Australian Government are generally limited such that intervention may require use of powers in other areas such as corporations or trade powers. Such intervention by the Australian Government would be treated as an exception and the majority of reforms need to be addressed through a cooperative approach to federalism in order to achieve an effective national outcome.

As powers over land transport are not specified in the *Commonwealth of Australia Constitution Act*, they lie, for the most part, with the States and Territories. For road transport, the Australian Government has made limited use of Section 92 powers to establish a partial regulatory scheme for vehicles engaged in interstate trade (the Federal Interstate Regulation Scheme), but has not yet attempted to use more recently established powers (for example, corporations powers) in applications relating to road transport operations. However, the Australian Government has made use of corporations and foreign trade powers to regulate new motor vehicle safety and environment standards through the *Motor Vehicle Standards Act 1989*. These standards are known as the Australian Design Rules. Civil aviation powers were ceded by the States to the Australian Government in the *Air Navigation Act 1920*, but no general agreement on road transport responsibilities occurred until July 1991.

As in most federal systems of government, there is continuing debate in Australia about the 'right' balance between national and sub-national (State or Territory) responsibility for various aspects of life, as well as the most effective models for intergovernmental cooperation. Land transport is no exception.

9.3 Early attempts at reform

Efficient transport, particularly for freight, has long been recognised as a key factor in the prosperity of Australia, with a vast land area, sparse population, long distances between major cities and significant journeys to global markets.

Each State and Territory regulates the operation of road vehicles with respect to vehicle standards, weights and dimensions. There was no constitutional objection to these regulations applying to interstate vehicles, as occurred for charges. For example, the vehicle dimension limits applied by a State were required to be observed by all vehicles operating in or through that State, no matter where the vehicle was registered. There was a Section 92 case against Victorian height and length limits applying to interstate trucks in 1960, but it was not successful (Inter-State Commission (ISC) 1986).

Prior to the establishment of the NRTC in 1991, national coordination of road transport regulation was undertaken through the Australian Transport Advisory Council (ATAC), comprising Federal, State and Territory Ministers for Transport. The process was advisory and relied on implementation by jurisdictions following consensus decisions.

Commencing in the 1970s, there were some gains in regulatory alignment for vehicles travelling interstate. However, as there was no binding decision-making process, progress towards national uniformity was limited.

Problems in the regulation of the road transport industry had been considered by the ISC, which was re-established in 1984 and was merged into the Industry Commission in 1990.[1] During its second existence, the ISC documented variations between jurisdictions in the regulation of road transport and made recommendations to the Federal Minister to consider, in conjunction with his colleagues in the ATAC (ISC 1988).

The ISC (1988) examined the harmonisation of vehicle regulations and suggested there would be benefits in more uniformity, although it was unable to quantify these benefits. A specific recommendation was for the Australian Government to mandate national design and construction standards for new vehicles. Differences in vehicle standards were reduced with the application of the Australian Design Rules which were developed over many years by working parties (within the ATAC structure) of federal, state and territory officials and representatives of manufacturers and road users. However, these were not adopted in all jurisdictions. The Australian Government used its constitutional powers to regulate the standards applying to new vehicles under the *Motor Vehicle Standards Act 1989*. Vehicles constructed by companies in Australia are regulated under the corporations power and imported vehicles under the external affairs power.

At the end of the 1980s, road transport in Australia was subject to a diverse array of differential State and Territory legislation, supplemented by federal regulation of specific aspects, primarily through the *Motor Vehicle Standards Act 1989* and the Federal Interstate Registration Scheme. State and Territory differences applied in road rules, driver licence categories, registration classifications and charges, vehicle mass and dimensions, driving hours and a range of other operating conditions and enforcement practices.

The situation for heavy transport trying to run an efficient interstate operation became so intolerable in the late-1980s that major road blockades were initiated, as well as other forms of protest. Regulatory disparities that rendered drivers and operators illegal as borders were crossed made the conduct of interstate trucking operations in Australia unnecessarily difficult.

For rail, prior to the 1990s, most railways were owned and operated by government. Regulation was applied through internal operating rules, and operation across borders was difficult.

[1] The Industry Commission later became the Productivity Commission.

9.4 Creation of the National Road Transport Commission

In 1990, an ISC report to Ministers (ISC 1990) recommended the establishment of the NRTC without any operational responsibility but with the role of coordinating the regulation of road transport nationally.

At this time, there was a widespread perception that the division of powers under Australia's federal system was acting as an impediment to economic efficiency and that this impediment had to be addressed to enable Australia to maintain a competitive position in an increasingly difficult world trading environment. In the road transport industry and amongst transport policy makers, there was a perception that the efficiency of road transport was impeded as it was a national industry suffering from differential regulatory treatment by States and Territories.

The release of the ISC report coincided with an unusual political environment when there was a strong view that Australia's future depended on far-reaching microeconomic reform. There was a period of about 18 months without a State or Federal election and Prime Minister Hawke worked with Premiers to achieve consensus outcomes at Heads of Government level (Moore and Starrs 1993). A number of Special Premiers' Conferences were called to address this economic malaise and there was an agreement at Council of Australian Government (CoAG) level, driven by central agencies rather than transport portfolios, that the establishment of the NTRC was an essential element of the way forward to address the inefficiencies in transport regulation that were impairing the performance of the road transport industry and the broader economy.

The NRTC was born out of this rare alignment of factors and was given a quite specific charter through two Inter-Governmental Agreements (IGAs): the Heavy Vehicles Agreement and the Light Vehicles Agreement. These were scheduled to the *National Road Transport Commission Act 1991* which included a six-year review period and a sunset clause signalling the view that the problem would be resolved within this time frame. The first review took place in 1996 and contained recommendations to extend the life of the NRTC, but with increased emphasis on outcomes rather than legislative process (ICRNRTL 1996). This led to a further six-year term for the Commission, with a renewed and slightly amended IGA.

The second review was concluded in July 2002 and was a broader review of institutional needs for land transport policy (Affleck and Meyrick 2002). This review recommended a new IGA replacing the NRTC with the NTC, with a remit including regulatory and operational reform in rail and intermodal transport as well as road transport. Hence, the NTC was established in 2004 under a new Act and the

sunset clause was removed and replaced by reviews triggered by the Australian Transport Council (ATC). This was a recognition that the experiment in national road transport reform was a success although there was still much to be achieved, that there needed to be a process for maintaining the national consistency of the agreed reforms in road transport and that the rail area would benefit from a similar reform process.

The second review also called for the establishment of the National Transport Advisory Council (NTAC) to consider issues related to transport infrastructure. This Council has not been established.

The process of road transport reform in the Special Premiers' Conferences capitalised on pressures which had been growing over many years for a more national approach to transport regulation. The political environment of the Special Premiers' Conferences provided the potential for the achievement of transport reforms which had previously been under active consideration. Involvement of central agencies facilitated the process. There is little sense in which the central agencies imposed their policy prescriptions on reluctant line departments.

A key feature of the Special Premiers' Conferences process was to direct the attention of central agencies to reform of the regulation of road transport, in a political environment where a 'crash through' approach was possible. In this way, the involvement of the central agencies enabled the creation of institutional arrangements designed to enable the achievement of the regulatory uniformity and consistency regarded by many as the core of road transport reform.

However, the items included on the reform agenda were not initiated by central agencies. The reforms considered arose from roads and transport areas and were derived from a long process of analysis and report. This process can be traced from the National Road Freight Industry Inquiry (NRFII 1984) through the work of the ISC and ATAC to the Special Premiers' Conferences. The Special Premiers' Conferences enabled the establishment of a structure for the achievement in some of these areas of reforms which had been discussed over this period. Had it not been for the political impetus generated by this process, it is unlikely that the national commission recommended by the ISC would have been established as a means to achieve reform. The specific regulatory reforms continue to be debated.

Whilst the NRTC commenced its work prior to the National Competition Policy Review, which was completed in August 1993, and the subsequent Competition Policy Agreements, implementation of agreed road transport reforms was included in the Agreements as one of the conditions of competition payments.

9.5 Method of operation

The Commission is comprised of six Commissioners, including the CEO, appointed by the ATC (comprising Federal, State and Territory Transport Ministers). It has a staff of 35 and an annual budget around $7 million.

The parties to the IGA, which gives the NTC its charter (Inter-Governmental Agreement for Regulatory and Operational Reform in Road, Rail and Intermodal Transport), have agreed to the following:

- the Parties affirm their commitment to improving transport productivity, efficiency, safety and environmental performance and regulatory efficiency in a uniform or nationally consistent manner (2.1);
- to achieve these objectives the Parties affirm their commitment to implementing and maintaining Agreed Reforms developed by the National Transport Commission and the National Road Transport Commission in a uniform or nationally consistent manner (2.2); and
- the Parties also agree that the primary focus of the reform and maintenance process should be on addressing matters that demonstrably warrant a uniform or nationally consistent regulatory or operational approach (2.3).

The responsibilities and functions of the NTC include to (5.1):

- develop uniform or nationally consistent regulatory and operational arrangements for road, rail and intermodal transport, including recommending to the Council Proposed Reforms and amendments to Agreed Reforms;
- monitor implementation of Agreed Reforms by the Parties and regularly report to the Council; and
- maintain and review Agreed Reforms.

In considering recommendations of the Commission, the ATC is bound by formal voting procedures. For most matters, if a legislative proposal is approved by a majority of Ministers, the model legislation is attached in a schedule to regulations made by the Australian Government under the NTC Act, thus providing a formal legislative repository for agreed national model legislation. The Australian (where relevant), State and Territory Governments are then required to take the national provisions through their own parliaments for local application. Whilst the terminology of a voting process based on 'non disapproval' which was used in the NRTC IGAs has been dropped from the NTC IGA, the effect has been retained as a Minister who does not vote is taken to have voted to approve. The requirement for a formal vote to take place is of significance, as it forces Ministers to make decisions on items forwarded by the Commission. It also ensures that 'lowest common

denominator' solutions need not apply, as a mechanism is provided which enables impasses to be overcome.

It is important to note that for most of its business, the ATC functions on the basis of consensus, with an agenda provided by the Standing Committee on Transport. However, for Commission items, the agenda and papers are provided by the Commission and a formal voting process is required. The Commission can take recommendations to the ATC either in-session or out-of-session. For most matters, a two month voting period is required. This is also significant, as it means that the NTC is not bound by timing of ATC meetings for achieving agreement on national issues. In fact, most policy issues of significance are taken to the ATC out-of-session.

The annual Work Program and the three-year Strategic Plan (updated annually) are also developed with extensive external input. The Work Program is presented annually to ATC as part of the budget request and the Strategic Plan must also be approved annually by Ministers. Thus the ATC formally signs off on the priorities for reform, ensuring there is a clear mandate and commitment.

An aspect of the NTC model which provides much of its strength is the decision-making requirement it places on Ministers. The Commission develops policy recommendations through a rigorous process and submits a recommendation for a proposed reform to the ATC. Ministers are given the option to either approve or disapprove the recommendation. Ministers cannot amend the recommendation. Although there have been cases where a Minister voted in favour of a proposal but added caveats, these caveats have no formal status. The recommendation becomes an Agreed Reform if there is a majority in favour (that is, five out of the nine ministers can carry the vote and establish agreement to the reform). Each Minister has a single vote so the larger States or the Australian Government cannot dominate the decision-making process. When a Proposed Reform is agreed, the Parties to the IGA are required by the Agreement (12.1) to 'use their best endeavours to implement and maintain Agreed Reforms in a uniform or nationally consistent manner'.

In the NTC IGA, this is subject to the caveat that (12.2):

> However the Parties acknowledge that, in exceptional circumstances, a … Reform may not be able to be implemented by a Party, for example due to policy or practical constraints. In order to provide clarity to the transport industry and the community as a whole, where a Party:
>
> - does not intend or is unable to implement a Reform (in full or in part); or
> - subsequently proposes changes to a Reform

> the relevant Minister will advise the Commission and the Council of the reasons for the decision at the earliest practicable opportunity.

This caveat represents a weakening of the NTC IGA compared to the NRTC IGA. It may reflect the fact that the more recent IGA was negotiated primarily by transport agencies, with little involvement of central agencies, and was signed by Transport Ministers, whereas the earlier IGAs were signed by Heads of Government.

The mechanism which was adopted initially to ensure reforms were implemented in a consistent and uniform manner involved NRTC, as it was then, preparing template legislation to be applied by the Australian Government in the Australian Capital Territory. The States and the Northern Territory were then to pass legislation adopting the Australian Government provisions by reference. Any amendments then applied automatically in all jurisdictions. It was intended that a complete body of National Transport Law would be developed through this mechanism. Template legislation was not widely applied due to concerns over loss of State/Territory sovereignty and the difficulty in integrating national provisions with existing bodies of legislation in each jurisdiction. Only two reforms were completed using the template mechanism: Heavy Vehicle Charges and Transport of Dangerous Goods.

Alternative mechanisms were then sought and now the NTC develops the reforms mainly through model legislation, guidelines or codes. Implementation of agreed reforms may vary between jurisdictions, much to the concern of industry stakeholders seeking nationally consistent outcomes. The Commission undertakes reviews to assess the extent and significance of those variations compared to the agreed policy. These reviews to date have indicated that, while jurisdictions have adopted different mechanisms, nevertheless, the intent of the reforms has generally been achieved. However, there have been some important exceptions, including lack of consistent implementation of agreed national mass limits.

This evolution of various mechanisms for implementation has been a strength of the model because it has been an essential element in reaching an agreed policy position by a majority of jurisdictions for a large number of reforms.

The Commission is required to monitor the implementation and manage the maintenance of reforms, with feedback from the jurisdictions indicating any improvements that should be made based on the experience gained during operation of the reform. In some cases, one of the jurisdictions champions the analytical work required to substantiate any changes and to gain the support of fellow regulators who are also learning from the practice of the reform. The Commission also initiates a major review of each area of reform in a cycle which meets the requirements of the legislation review period in the jurisdictions. For example, a review of Heavy Vehicle Driving Hours model legislation introduced in 1996 is

currently underway. The review is providing the opportunity to significantly improve the policy approach by introducing the concept of Fatigue Management to supersede the previous policy of simply managing the hours of driving. This is an example of another of the strengths of the model as it provides a platform for national learning and has resulted in Australia achieving a position at the forefront of many aspects of transport regulation internationally.

In order to achieve its tasks, the NTC must work with a wide range of participants. Stakeholders include road regulatory authorities, road transport enforcement agencies (police and transport inspectorates) and the road and rail industries. Particularly in road transport, which is diverse and dominated by small operators, industry consultation is a significant exercise.

Other aspects of the NTC's role require liaison with dangerous goods authorities, environmental agencies, occupational health and safety authorities, shippers, stevedores and primary producers.

Nearly all of the NTC's work requires extensive consultation with outside agencies and industry representatives. In most cases, some form of joint policy development is undertaken. This could range from intensive focus groups to more formal arrangements (typically the case with environmental matters) or use of transport agencies as 'lead agencies' in the national process.

A good example of cooperative policymaking was the process followed in the development of the Australian Road Rules (Shepherd and Calvert 1999). Over a period of five years, meetings were held of up to 30 representatives (mostly of road authorities and police) chaired by the Commission and with analytical work undertaken by all participants. Public consultations were a feature of policy development, both nationally and within jurisdictions. The result was a product with shared ownership which was successfully implemented (in most elements) in all jurisdictions. This success in reaching a (largely) common set of road rules throughout Australia followed numerous failed attempts which started in 1948.

The Commission has a range of formal advisory groups including Transport Agency Chief Executives, the (road freight) Industry Advisory Group, the Bus Industry Advisory Group, the Rail Safety Package Steering Committee and (jointly with the National Environment Protection Council) the Land Transport Environment Committee (previously the Motor Vehicle Environment Committee).

9.6 Achievements

Prior to the establishment of the NRTC in 1991, the ISC had identified inconsistencies in State/Territory regulation of heavy vehicles. Most of these inconsistencies were addressed in the early years of operation of the NRTC. Over a period of time, substantial progress was made in national consistency in prescriptive regulation in a range of areas. The primary reforms delivered in the initial work of the NRTC and the next two packages, basically covering the period up to the late-1990s, included:

- transport of dangerous goods;
- uniform registration and licensing schemes for heavy vehicles;
- uniform operations for exemptions to general access vehicles;
- driving hours for heavy vehicles;
- vehicle standards;
- Australian Road Rules;
- heavy vehicle charges (for registration and fuel);
- compliance and enforcement legislation;
- safe carriage and restraint of loads;
- higher mass limits;
- managing speeding heavy vehicles; and
- vehicle noise and emission standards.

On a simplistic scorecard, of a total of 31 reforms in these packages over half have been implemented in all jurisdictions and 80 per cent have been implemented in a majority of jurisdictions.

Differences in standards (for example, mass limits) exist due to incomplete coverage of national regulations or delayed, incomplete or inconsistent implementation by jurisdictions.

The reforms in the Third Heavy Vehicle Reform Package, commenced in 2002, and the rail projects, commenced in 2004, include some which will have far reaching implications for the way the transport system operates in this country.

Notable in this regard are:

- development of a performance-based approach to determine conditions of access for heavy vehicles as an alternative to the current prescriptive system;

- introduction of the concept of 'chain of responsibility' in compliance and enforcement model legislation to ensure that any party who has control in a transport operation from consignor right through to receiver of goods can be held responsible for the safety outcomes;
- introduction of new standards for vehicle emissions and fuel to significantly reduce the environmental impact of transport over the next five years; and
- development of a framework to improve and strengthen the co-regulatory system for rail safety and a national policy on key rail safety issues and procedures and standards to manage major rail safety risk factors.

Painter's (1998) comment on the performance of the NRTC was:

> The NRTC had established itself as a legitimate, respected and significant player in the transport policy sector, adopting for itself the role of 'independent catalyst for broad-ranging road transport reform in Australia'…. This form of words, drawn from the communiqué issued after the February meeting [which extended the NRTC's life for a second six-year term], reflected the lowering of expectations that had occurred as a result of the experience of implementing reform. The steadier, less dramatic and more piecemeal approach that the NRTC came to adopt in the face of implementation difficulties was one that the States felt comfortable with, and their continued support was forthcoming precisely because the NRTC recognised the practical limits to the lock-step [template legislation], collaborative procedures set out in the original agreement.

The second review of the NRTC made an assessment of the dollar value of the reforms over the previous 12 years and estimated this to total $400 million plus the environmental and other social and community benefits (Affleck and Meyrick 2002).

In its early years, the focus of the NRTC was on the removal of the obvious disparities in prescriptive regulation between jurisdictions. With some notable exceptions, this task has largely been completed, albeit with a degree of road transport industry discontent over differences in implementation and enforcement.

In the second phase of its work, commencing in the late-1990s, the Commission has shifted its focus to regulatory innovation, with a broader emphasis on the most effective means of achieving the community's objectives of safe, sustainable and efficient land transport. Key elements of this phase have been:

- development of a proposal to shift the emphasis of the regulation of heavy vehicle driver fatigue from prescriptive regulation of hours of work to a more flexible approach based on the management of fatigue precursors;

- development of national compliance and enforcement provisions for heavy vehicles which have spread responsibility for compliance beyond drivers and transport operators to others in the transport chain;
- development, in conjunction with Austroads (the collegiate of State/Territory road agencies) of the Intelligent Access Program, to enable satellite-based monitoring of breaches of compliance conditions for vehicles granted differential access to the road network; and
- supplementing prescriptive regulation with an option of performance-based standards, where operators can develop innovative vehicles and combinations, subject to meeting a range of safety and asset protection standards.

Taken together, these developments will enable continuing innovation in road transport whilst increasing community confidence in the behaviour of heavy vehicles.

Over the longer term, performance-based standards is seen as the key productivity reform that replaces one-size-fits-all rulemaking, as it will provide a regulatory framework for operator-driven flexibility in vehicle design and operation, subject to agreed safety and asset standards. Performance-based standards are seen as a key element in a regulatory approach to road transport which will enable continuous productivity gains and technological improvement, whilst meeting reasonable safety, road asset protection and environmental standards. However, it will need to be able to provide a genuinely national regulatory framework for operator-driven flexibility in vehicle design and operation, with safety and asset protection standards which are not excessively conservative.

The performance-based standards approach is seen as one part of a new regulatory paradigm for road transport regulation. The basis of this paradigm is to enable productivity improvements, whilst meeting reasonable expectations of safety and environmental performance. This provides a rationale for road transport productivity reforms built on a foundation of effective compliance mechanisms, 'first world' safety and environmental requirements, and efficient implementation of regulation. Some of the elements of this approach are in place while others are under development. The basis of the approach is to position appropriate safety and environmental requirements, combined with assurance that these requirements are met, as prerequisites to community acceptance of more highly productive vehicles. This approach is seen as a bridge between the currently divergent views of those who place greatest emphasis on the productivity objective and those who place greater weight on safety and environmental outcomes.

In the case of rail, the current emphasis is on the development of a seamless national regulatory regime, commencing with a national Rail Safety Bill, to be

followed by regulations, codes and guidelines. This approach will maintain the current co-regulatory approach, whilst aiming to achieve consistency between jurisdictions.

9.7 Road pricing

An appropriate road pricing regime for heavy vehicles is seen by many as a key requirement in the development of an efficient land freight industry.

Heavy vehicle pricing for road access is currently determined by ATC following recommendations from NTC and is then implemented by jurisdictions. Charges are based on recovery of past road expenditure (including both capital and maintenance and averaged over the three previous three years) and are applied to vehicle classes on the basis of estimates of expenditure allocated to each vehicle type. The process is complex and involves judgements. The charging instruments are a registration charge (paid to State/Territory Treasuries) and a fuel charge, paid to Federal Treasury through diesel excise. About 70 per cent of total cost recovery is through the fuel charge and 30 per cent through registration charges. The result is full expenditure recovery by vehicle class, but with some under-recovery within class for vehicles which are heaviest and travel the longest distances and over-recovery from vehicles which are lightest and travel the shortest distance.

This system is based around averages:

- for mass and distances for vehicles within a class;
- for cost allocation relationships across road types; and
- for expenditure over a (retrospective) three year period.

Currently, the NTC is developing the Third Heavy Vehicle Road Pricing Determination, for recommendation to ATC in December 2005. This will lead to the implementation of revised charges (both fuel and registration) in 2006. The Third Determination will be based on revised road use, road expenditure and parameter estimates, but will not include fundamental changes in methodology or institutional arrangements.

The intention of the second review of the NRTC was that the NTC would set heavy vehicle road prices on the basis of infrastructure pricing principles developed by the National Transport Advisory Council and endorsed by ATC. As the NTAC has not been established, the Third Determination has been undertaken on the basis of a set

of principles developed by the NTC and endorsed by the ATC in August 2004.[2] These principles are:

National heavy vehicle road use prices should promote optimal use of infrastructure, vehicles and transport modes.

This is subject to the following:

- full recovery of allocated infrastructure costs while minimising both the over and under recovery from any class of vehicle;
- cost effectiveness of pricing instruments;
- transparency;
- the need to balance administrative simplicity, efficiency and equity (for example, impact on regional and remote communities/access); and
- the need to have regard to other pricing applications such as light vehicle charges, tolling and congestion.

(Note: These principles allow for the inclusion of variable mass distance charges and externality charges relating to noise and air emissions where: (i) there are clear net economic gains; (ii) the extent of effort is recognised; and (iii) transparency and more accurate pricing within the road mode are ensured.)

In Australia, there is no linkage of road charges with optimal road expenditure, no provision for charging for externalities and no hypothecation of charge revenues to road expenditure (with the exception of one State where registration revenues are hypothecated to road expenditure at an aggregate level). Local government, although responsible for a substantial proportion of road expenditure receives no revenue directly from the current charges.

Hence, it is not surprising that road agencies are reluctant to allow increased mass, knowing that this will lead to more rapid deterioration of their asset without any direct linkage to the revenue required to maintain/enhance the asset. From the perspective of the transport industry, there is no mechanism to choose to pay for a higher level of asset consumption, irrespective of the potential productivity benefits.

[2] Under the IGA, one of the functions of the Commission is to (5.1 c):

(i) develop road use charging principles for Heavy Vehicles (until such time as the Council decided that another organisation should undertake this function); and

(ii) develop Proposed Reforms in relation to Heavy Vehicle Road Use Charges based on charging principles agreed by the Council from time to time.

Adoption of a new approach to road pricing for heavy vehicles would need to involve central agencies as well as road agencies, as it cannot be separated from current revenue and funding arrangements.

The NTC has initiated a project to scope the work required to move, in the Fourth Heavy Vehicle Pricing Determination, to pricing based on mass, distance, road type, and so on for individual vehicles. It is intended that this project will be an input into a broader review of infrastructure pricing to be initiated through CoAG processes.

Whilst there are widespread views that heavy vehicles are currently undercharged for their use of the road network and that more sophisticated pricing arrangements would lead to modal shift from road to rail, it is not clear that this is the case. The effects of class averaging, which leads to under-recovery from the heaviest vehicles and those travelling the longest distances are generally small relative to total charges and to operating costs. Further, cost-averaging across road types may lead to under-recovery from the vehicles which use the most durable roads, and these are probably the vehicles that compete most directly with rail. Potential charges for externalities would be lowest in non-urban areas, where road and rail are most contestable, and greatest in urban areas where there is little substitution between road and rail transport.

Linkage of road use and road expenditure would enable road freight operators to choose and pay for a level of consumption of the road asset and pass that revenue on to road owners for asset maintenance, enhancement or expansion. If road owners were confident that they would directly receive infrastructure-related road revenues, they would have an incentive to respond to demands for the operation of higher mass vehicles. Provided compliance, safety and environmental standards were met, this would lead to improvements in efficiency (through more productive vehicles), safety and environmental sustainability (through reduced numbers of heavy vehicles).

In effect, more sophisticated pricing and funding arrangements would enable the replacement of mass limits applied to vehicle classes by individual choice of mass limit by transport operators. Furthermore, the signals provided by such accurate pricing could encourage the optimal level of investment in roads.

Infrastructure related costs for road transport are generally low in relation to operating costs. For this reason, it is possible that greater accuracy and flexibility in road pricing, enabling road transport operators to choose (and pay for) the optimal level of asset consumption would improve the competitive position of road in relation to rail.

In addition, current rail access prices are often below a level which provides full recovery of infrastructure costs.

In order to optimise the efficiency of land transport in Australia, the primary objective of a more refined road pricing system would be to more directly link road use, road wear and road expenditure, particularly for freight vehicles.

Linkage of road wear and road use would potentially enable attribution of road costs by axle mass, road type and road condition. Attribution of these costs to individual vehicles would mean that they would be factored into route choice, vehicle choice, axle mass and vehicle configuration by transport operators and into mode choice by users of transport services. In the event of the application of similar methodology to other modes, this would assist optimisation of freight across transport modes.

Moving away from highly aggregated charges to a system where the charges more accurately reflect the costs of road use has the potential to yield efficiency gains. There is an unavoidable caveat — the cost of such a system. The main components of the cost would be ensuring reliable estimates of the costs of road use and the cost of introducing and running the system.

In Australia, pricing aimed at traffic demand management (congestion pricing) would include freight vehicles but not be specific to them, as they constitute only a small proportion of the traffic stream. This form of pricing could encourage freight applications to switch to use of the infrastructure outside of peak thus improving utilisation of the road network, but would have no direct effect on infrastructure provision.

Road prices based on location, vehicle type and time of day would facilitate the application of externality pricing. Effective application of externality pricing would depend on knowledge of location and time-specific externality values and an assessment that this form of pricing is warranted, given that more direct regulatory means to address some key externalities have been set in place (through emissions standards). It would also provide a different means of rationing access to congested components of the road network, in place of the queuing approach that is effectively used at present.

An advantage of the current system of fuel and registration charges is that administration and compliance costs are low (as the registration transaction is required for heavy vehicle compliance purposes, the addition of a revenue component adds little cost). Also, the informational demands of the current system are minor compared to accurate point-of-use pricing. The full costs of any alternative system would have to be assessed against the benefits.

9.8 Keys to the effectiveness of the NRTC/NTC model

There are a number of key features of the model that have led to its successful operation over the past 14 years. These include:

- The initial Heads of Government level Agreements:
  - The initial process was part of the Special Premiers' Conference processes, included extensive involvement of central agencies and resulted in an IGA signed by Heads of Government. This CoAG-level of endorsement was a key factor in the success of the initial reform agenda.
- The specific nature of the NTC charter:
  - The role of the NTC is limited to regulatory reform where national consistency can be expected to have a significant impact.
  - The NTC has no role in infrastructure planning or funding.
- The robustness of the policy development process:
  - Wide stakeholder consultations and a Regulatory Impact Statement process meeting CoAG guidelines underpin every policy proposal submitted to Ministers.
  - ATC sign-off on a three year rolling strategic plan and associated funding each year and, hence, there are no surprises when policy proposals are submitted for a vote.
- The decisive nature of the ministerial voting process:
  - The requirement to vote, the definitive rules for reaching resolution and the majority basis of most decisions mean there is a clear course of action following the submission of each policy proposal.
- High level advisory bodies from industry and government:
  - Engagement at CEO level enables the Commission to ascertain the level of support and provides opportunity to influence hearts and minds prior to preparation of formal recommendations to ATC.

9.9 Limitations of the model

Whilst the NRTC/NTC model of regulatory reform has had considerable success, there has been strong criticism from the road transport industry of variation in implementation. In addition, there is concern that the focus of road transport is shifting from prescriptive regulation, which has been the focus of efforts to date, to performance-based regulation, where national approaches have not yet been agreed.

One of the most apparent limitations of the NTC model is in the implementation phase of reforms when individual jurisdictions may choose to diverge from the policy intent or implement only after a considerable delay. The NTC has no power to require consistency in the implementation phase and can only report divergences to the ATC to take action to address these inconsistencies. As a general rule, Ministers do not bring peer pressure to bear to achieve consistency when the reasons for the divergence are strongly held by the particular jurisdiction involved. Reasons for departures from consistent implementation include:

- staff turnover in transport agencies, with new staff not understanding the need for adherence to the national model;
- transport agencies not agreeing with the national proposal; and
- transport agencies considering that the national model can be improved through local divergences.

The NTC model is intended to oblige jurisdictions who vote against a proposal to implement it if there is majority support. However, the lack of anything more than persuasive power and industry pressure limits the effectiveness of the NTC in ensuring that this occurs. Other than linkage of some reform proposals with national competition payments and the National Competition Council assessment process (see below), there has been no independent umpire.

The NTC has acknowledged that some divergences to the national model may be required to retain consistency within jurisdictions, for example in penalties in other areas of law or with broader criminal justice policies. For this reason, national penalties are proposed as model only, with an expectation of local variation, and some elements of the compliance and enforcement reform were designated as 'desirable' rather than 'essential'.

Implementation of national reforms can vary significantly in time due to the difficulty in securing passage through State/Territory Parliaments and internal resourcing difficulties in transport agencies. Following ATC approval of a legislative reform, local implementation can take from six months to several years, depending on local resources, access to parliament and the priority given to the reform.

These difficulties in the timing and consistency of implementation are the source of considerable frustration, both to the NTC and the national road transport industry.

Whilst the initial IGAs pre-dated the National Competition Agreements, competition payments were subsequently attached to implementation of agreed road transport reforms. These payments increased the incentive to implement reforms through encouraging road agencies to allocate the required resources and

empowering them in their efforts to seek parliamentary passage. As a list of specific road transport reforms was not available for inclusion in the National Competition Agreements, competition payments for road transport regulatory reforms were based on subsequent ATC decisions through a process of designating assessable reforms, prior to assessment by the NCC of implementation of these reforms. Designation of the list of assessable reforms was undertaken by federal and state/territory road and central agency officials and some contentious reforms were not included as assessable. The NRTC was instructed by the ATC not to assist in the NCC assessment process.

On balance, linkage of implementation of agreed reforms to competition payments probably accelerated implementation of road transport regulatory reforms, but some perverse incentives were created when the assessable reforms were not identified prior to the signing of the competition agreements.

Perhaps the most obvious area for improvement in the reform process would be to establish an institutional framework which provided, as a guide to the direction of regulatory reforms, a nationally consistent approach to policy development more broadly (including infrastructure provision and funding and pricing principles for the use of transport infrastructure) and also added some teeth to consistency in operational matters associated with the implementation of the Agreed Reforms. An important consideration is whether this would, in effect, require States and Territories to cede powers over land transport. The risk if this is not addressed is for the NTC, as the only national body in this reform area, to be thrown problems which really stretch the boundaries of its currently well-defined mandate.

There are two levels at which the national process must be assessed:

- in generating agreement to national policy; and
- in providing decision-making mechanisms for operational decisions (for example, on road access for specific vehicle types).

It is arguable that the key weaknesses in the national land transport regulatory reform framework are related to processes, rather than specific reforms. These weaknesses include:

- a protracted process to obtain agreement on a reform;
- delays and inconsistencies in implementation; and
- unwillingness of jurisdictions to cede decision-making power to national processes (this applies to recognition of decisions made collegiately or in other jurisdictions).

A key issue to be addressed in assessing the future direction of road transport regulatory reform is the decision-making processes required to achieve productivity gains at the national level. In the past, the bulk of freight activity has taken place within the framework of prescriptive regulation, where most operating conditions and regulatory decisions (for example, registration, licensing, mass limits) achieve full mutual recognition. Beyond this framework, there have been a small number of permit vehicles which receive local approvals (for example, cranes, low loaders). This has not been a major issue as these vehicles are generally intended for local operation only. However, it is likely that an increasing proportion of the future freight task will fall outside the prescriptive envelope, where automatic mutual recognition does not apply. Under current jurisdiction attitudes, this will include innovative operations under the Intelligent Access Project and Performance-based Standards, where decision making requires unanimity, and Advanced Fatigue Management, where each jurisdiction will determine local operating conditions.

In general, operation within the prescriptive framework is 'as of right' (that is, operations can be undertaken until a breach of standards is demonstrated by an enforcement agency). Outside this envelope, operation is generally seen as a privilege, where agencies can require an operator to demonstrate that he or she should not lose the right to operate. This reduced confidence in the right to operate may lower incentives to invest in innovative solutions.

The achievement of productivity improvements over the longer term will require the development of binding non-unanimous decision making or mutual recognition for road transport operations outside the prescriptive envelope.

9.10 Alternative models

The previous section contained a discussion of means of strengthening the current cooperative approach to land transport regulation. Alternatives to this general approach either involve reversion to a less structured national approach, with less likelihood of achievement of nationally consistent outcomes, or a more centralised approach.

A more centralised approach could result from some form of formal ceding of powers by States and Territories or unilateral use of Australian Government powers.

Given the extent to which land transport, particularly road transport, permeates the community, it is most unlikely that State/Territory Governments would be keen to cede regulatory powers. Also, given the extent of local issues involved in land transport, again particularly in road, and the inseparability of freight issues from

broader road use and community access issues, it is unlikely that the Australian Government would be keen to assume control and political responsibility.

It is interesting to note that, while the Australian Government funds a significant proportion of roads expenditure, it has rarely tied this expenditure to regulatory issues. This is in contrast to some other areas of federal expenditure in Australia and to the situation with federal funding of roads in the United States.

One possible model of land transport regulation is for States and Territories to effectively cede power to jointly established decision-making processes. Attempts to date to establish these processes in road transport regulation have failed, as States and Territories have retained control of operations on their own road networks.

While a comprehensive review of international arrangements for transport regulation in other federal systems has not been undertaken, some casual observations can be made:

- Despite the considerable variety in federal structures, other federal systems appear to face much the same problems as Australia.
- The national arrangements put in place in Australia through the NTC process appear to go further than in some other federations:
  - Canada's approach is purely cooperative and lacks a decision mechanism.
  - the United States relies on separation of powers and uses funding to coerce States to follow national arrangements. In the case of vehicle standards, this mechanism is restricted to the federal highway system, resulting in disparate standards applied to other parts of the road network.
  - the German system leads to lowest common denominator outcomes through the absence of majority decision rules.
- The European Union, while not strictly a federation, may provide the closest analogy to Australia. The EU system is cumbersome, not surprisingly considering the strong differences in culture, language, legal systems and institutional arrangements; and has had difficulty addressing productivity issues in both road and rail transport.

9.11 Conclusion

At the very least, the history of the NRTC/NTC is an interesting experiment in cooperative federalism.

In an institutional context of State/Territory primary responsibility for the regulation of road and rail transport and a reluctance to refer powers to the Australian

Government, the Commission has had reasonable success in developing and maintaining national uniformity or consistency in vehicle standards and conditions governing vehicle operation.

The strident road transport industry complaints over differential regulation which were common in the late-1980s and early-1990s are now more muted, with the exception of recent industry concerns over the possibility of increases in road user charges. The road transport industry, through its representative forums, has become a supporter of the continuing existence of the NTC or a like body.

The NRTC/NTC model has proved an effective mechanism for joint development, with environmental regulators, of vehicle noise and emission standards. It has provided a forum for more effective exchange of ideas and information between road authorities, and between road authorities and agencies with related responsibilities.

The Commission has completed much of its initial agenda, providing a base for the development of more innovative approaches to the regulation of road transport. It has proved an effective mechanism for aligning the regulatory approaches of different agencies impacting on road transport. Some of these achievements might be described as 'picking the low hanging fruit'.

The ability of the Commission to introduce innovative approaches to road transport regulation by drawing on developments in other regulatory spheres (for example, performance-based standards, compliance and enforcement, alignment of road transport and occupational health and safety) is proving to be a longer-term process and significantly more difficult. However, it supports the notion of an agency freed from line responsibilities and able to concentrate on broader policy issues.

The early debates on the need for a strong method of delivery through template legislation versus concern for loss of State/Territory sovereignty inherent in that process are no longer heard. A strong consensus has developed in favour of joint policy development with outputs generally expressed in the form of model legislation. Retention of the formal voting process has assisted in the achievement, to date, of reasonable success in national implementation of proposals developed under NTC processes.

Application of the current model in the more complex areas which involve not only the transport industry and portfolio but also other sectors and portfolios (for example, environment, central agencies, occupational health and safety), requires a far greater level of cooperation and engagement.

It is clear that the current process has not been effective in delivering consistent national outcomes in some key areas of regulation (for example, mass limits). It also appears that the model will have difficulty delivering national consistency beyond the prescriptive regulatory regime. Importantly, movement beyond this regime is a key to ongoing improvements in road transport productivity.

The Commission has only had its mandate extended to cover rail regulation and is working with rail regulatory and policy agencies and the rail industry in the development of rail safety policy and legislation. Whilst much of this work has not yet come to fruition, the national mechanisms have enabled constructive engagement at the national level and should result in a platform for the implementation and maintenance of nationally consistent rail safety regulation. However, some key issues relating to institutional arrangements have not yet been addressed in the national process and consistency in implementation between jurisdictions is yet to be tested.

Other than through a shift of responsibility from States and Territories to the Australian Government, sustained regulatory reform in land transport will require significant enhancements to current processes. Whilst the national process was intended to break though local issues, it has become something closer to a consensus process. It is arguable that this is inevitable for a body which is funded by transport agencies and must rely closely on transport agency expertise and cooperation. Whilst these processes have been strong enough to achieve national resolution of many of the issues of the 'old' regulatory agenda, it is questionable whether they will deliver continuing productivity improvements. Strengthening the cooperative process requires the involvement of the Australian Government and State/Territory central agencies, in order to overcome reluctance by transport agencies to always align local policies and processes with national outcomes. In some cases (for example, priority access to State/Territory parliamentary processes) line agencies seek this form of intervention to strengthen their case.

Key elements of a revitalised national regulatory reform process for land transport must include:

- Continuing involvement of CoAG.
  - This involvement is required to provide the broader national context and priorities and to reduce the likelihood of defensive responses by line agencies. Involvement of CoAG will also assist line agencies to attain the local priority (including in resourcing and access to the parliamentary process) required to achieve national goals.
- Binding decision-making mechanisms with cross-border application.

  - Achievement of ongoing productivity improvement in land transport will require innovation outside the coverage of past prescriptive regulation, particularly in road transport. This will require the development of a new regulatory paradigm, including binding decision-making mechanisms, enabling widespread and seamless operation of innovative vehicles (for example, performance-based standards vehicles) or regulatory approaches (for example, Advanced Fatigue Management).
- Assessment of the performance of jurisdictions against agreed goals.
  - This could involve tied federal funding or some form of assessment, similar to the earlier assessments against the National Competition Agreements. It is arguable that the NTC, which is closely involved in the development of reforms, is not the best body to assess or enforce implementation. Any form of assessment must involve the question of how goals are agreed.

Addressing these issues may lead to a reassessment of the current role of the NTC. Currently, the NTC is funded by transport agencies and reports directly to the ATC. Transport Agency Chief Executives are utilised as an advisory body. The Commission works in a close and cooperative arrangement with both road and rail transport agencies and is heavily reliant on them for information and expertise. Creation of a process where ATC processes and outcomes are assessed in some way by CoAG raises the issue of whether the NTC would have a more direct line of responsibility to CoAG.

Any amendments to current processes may also require a renegotiation of the IGA and consideration of the level of government at which an IGA should be signed. The current IGA was signed by Transport Ministers and amendment requires unanimous approval.

It is clear that any model of regulatory reform needs to be continually reviewed and enhanced, particularly in areas of decision making, to accommodate the scope of the reform task.

The Special Premiers' Conferences had the effect of pushing road transport reform onto a wider political stage in an environment where problems were being identified and solutions sought. Whilst the issues and many of the solutions were derived from road transport constituencies, the role of central agencies was essential in restructuring policy making institutions. We have now come full cycle, with regulatory reform in transport again being raised onto the CoAG agenda, due to concerns over the ability of the current model to deliver the outcomes necessary to meet community needs.

If the current opportunity is not seized to force a higher level reform agenda for land transport, to develop the necessary institutional arrangements and to provide the power to obtain sustainable national outcomes, the role of the NTC will degrade over time to a body seeking consensus among diverse interests on issues of little importance.

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In my comments on these two very valuable papers I want to make four points. First, current road charges are inefficient. Second, while the fact of that inefficiency is widely accepted, it is controversial whether a move to more efficient road charges would have much impact on the modal balance and, in particular, would in and of itself shift significant traffic from road to rail. Third, such a move would nonetheless be well worth having, as it would allow improvements in the management of the road network and more generally of the transport system. And fourth, addressing the weakness of Australia's rail system primarily requires attention to its structure, and notably to the extent of vertical and horizontal integration.

Current road charges

First, current road charges. These are a two-part price, with the fixed element being the registration fee and the variable element being the fuel excise. As Wilson and Moore say, the process of determining these charges 'is complex and involves judgments'.

The relationship between these charges and economically efficient road prices is at best indirect. In principle, road users should face the marginal social cost of vehicle use.[1]

There is a reasonable degree of consensus on the component of these marginal social costs that is associated with road damage. The damage a vehicle does to the road pavement is a power function of its axle load — with a standard estimate (which though widely quoted, has not been demonstrated using Australian data) being that damage increases as the fourth power of axle load. Given such a power relation, almost all vehicle-caused damage is due to heavy vehicles. However, the *extent* of the damage on any particular road depends on its thickness, with increases in thickness dramatically increasing the number of vehicles that can be carried

[1] That marginal social cost is the sum of the marginal private cost of driving — that is, fuel, wear and tear on vehicles, drivers' time — and the marginal social cost of road use. The latter, which is generally referred to as *road use costs*, includes the costs involved in constructing, operating and maintaining the road network, the costs each driver imposes on other drivers (mainly congestion), and the pollution and accident costs that are borne by society as a whole.

before repairs are needed. As a result, the marginal road damage cost associated with freight vehicle use will be much greater on thin roads, such as minor country roads, than on the thick interstate corridors. Damage related charges should therefore depend not only on mass and distance but also on the links being traversed.

Current road charging arrangements cannot reflect these damage related costs. Fuel use is highly correlated with distance traveled, but not with axle loading. Combined with a fixed registration fee, a uniform fuel tax results in a unit charge which declines with the product of mass carried and distance traveled and which in any event does not vary according to the corridors used, as would a charge based on marginal road damage cost.

Impact on modal choice

Corridor-specific prices based on marginal road damage would provide better signals. However, and this is my second point, it is unlikely that they alone would shift the modal balance between road and rail.

In effect, road charges for heavy freight vehicles based on damage costs would be highest on country roads, where rail only competes for grain transport, and on the east-west corridor, where the rail share is already relatively high. However, on the north-south east coast routes, where the rail share is lowest, variable road charges would be low.

As a result, whether efficient pricing would entail a modal shift depends on whether efficient prices are materially higher than corridor-specific marginal road damage costs. This in turn depends on two factors.

The first is the non-road damage marginal costs — that is, the social marginal costs associated with congestion, accidents and pollution, which need to be added to marginal road damage costs if prices are to be efficient. Rod Sims argues that these added costs are substantial and will result in high marginal social costs for heavy vehicle freight transport. That claim is controversial.

Thus, marginal congestion costs for interstate freight on the main trunk routes are unlikely to be high. As regards accident costs, the relation between marginal changes in traffic flow and accidents is uncertain, and accident costs are in part already internalised through insurance payments and tort costs. Finally, whether environmental costs outside metropolitan areas are significant depends heavily on one’s view of the extent of, and appropriate response to, greenhouse gas emissions.

The second is whether efficient prices require a mark-up over marginal social costs: that is, whether it is second-best road use prices, which could be higher than marginal costs, and not first-best prices, which are equal to marginal costs, that are the relevant benchmark.

Such a mark-up in road user charges over marginal costs could arise from one of two sources.

First, if there were economies of scale to roading, with fixed costs resulting in marginal costs that were below average road costs, then there could be a case for marking road charges up over marginal costs so as to achieve full cost recovery. However, the existence of decreasing costs for roading is not established, at least across the network as a whole. Moreover, the modern theory of public finance suggests that the distortionary taxes required to fund any such shortfall should fall on final consumers rather than on intermediate users. The optimal taxation argument for funding the fixed costs of the road network through charges on freight transport is therefore controversial.

Second, in principle, it might be desirable to increase road prices over marginal costs if rail prices were themselves above marginal costs. But it is not clear that this is the case for inter-modal freight, or if it is the case, that the extent of the gap is sufficient to make much of a difference, given the starting point in terms of relative prices: that is, given the fact that current variable road charges on the major and thicker north-south routes may themselves be above marginal costs.

Other benefits

The effect of moving to efficient pricing on modal choice therefore remains an area of active controversy. However, and this is my third point, that certainly does not mean that efficient road charging is not well worth having.

Whatever the efficient long-term modal split may be, corridor-specific road charges, based on the marginal cost of road use, could only help secure it. Additionally and importantly, they would facilitate efficient investment decisions in the transport network, as they would permit greater reliance on, and more consistent comparisons of, expected revenues and expected costs. Moreover, they would open the door to reconsidering the governance arrangements in road network management, with the potential to allocate responsibility for both revenues and costs to the level of government which is best placed to capture the social effects of the relevant decisions.

This last point seems to me of great importance, and would merit closer consideration in both papers. The fact of life is that we are moving towards a road network where certain parts are priced, with the resulting revenues being hypothecated to the service provider, while others are not. This partial hypothecation, associated with the reliance on privately financed toll roads for major extensions to the road network, can be inefficient inter alia in so far as priced and unpriced roads are substitutes. Impetus to that hypothecation comes in part from the current vertical imbalance between road outlays and road-related receipts. A better alignment between these based on allocation of the receipts from proper road charging would allow better targeted use of privately-financed roads and could help better measure and remunerate the services those roads provide. For example, privately-funded roads could be recompensed on the basis of the change in congestion that they allowed in the relevant road transport area — which is a generally more efficient basis for determining the return to a road operator than a point-to-point toll.

The future of rail

As for the rail network, and this is my fourth and last point, there are deep structural issues that need to be addressed if the rail system is to overcome the service quality and infrastructure adequacy issues that prevent it being fully effective.

I do not know anyone who believes that the current structure of the rail industry in Australia makes sense from a long-term perspective. We have full vertical integration in the north and the west, and a curious mix of integration and separation in the south east. Superimposed on this jigsaw is the ARTC, which is less a structure than a mission, with some assets and funding at its disposal. Even those who are most supportive of this mix would defend it as transitional, but that merely begs the question of transitional to what.

In my view, there are two broad models that are conceivable as long run options. A first is the Swedish model, in which above- and below-rail are separated, the below rail network being treated much as if it formed part of the road system. More specifically, below rail charges are based on marginal costs, which are far below average costs. The resulting shortfall, and hence investment in rail, is funded through consolidated revenue, on exactly the same basis as road.

The main advantage of this model is that it can provide for neutrality in intermodal investment choices, while still allowing competition in the above-rail component.

A second approach that could emerge is similar to that in the US, where there is a small number of ‘Class I’ rail operators. These operators are vertically integrated

businesses that operate in neighbouring regions. Given each of the railroads is vertically integrated and needs to operate in other networks, there is little benefit in one owner seeking to overcharge another for access to its network. As a result, the rail owners have a voluntary agreement in place to share access to each network on a reciprocal basis.

The main benefit of this model is that it allows the economies of vertical integration to be realised, albeit at the cost of reduced contestability in the above-rail component. As these economies are very substantial, the result can be large efficiency gains, both with respect to operating costs and with respect to capital productivity.

The first of these options — a Swedish-like separation of above and below rail — seems less plausible than the US model as a direction for future Australian development.

To begin with, for a transposed Swedish model to work, some way would need to be found of combining responsibility for the rail infrastructure on a national basis — but there is no obvious process which could yield this outcome. Additionally, even if there was such a process, it is difficult to see Australian governments accepting to fund rail infrastructure out of consolidated revenue on a public good basis, as happens in Sweden. Finally, the Swedish model sacrifices the efficiency of vertical integration, which in rail is considerable.

In contrast, given the shift toward a consolidated rail market in Australia in recent times, with each of the major players operating at least one network across mainland Australia (that is, Pacific National in Victoria, QR in Queensland and ARG in WA and SA), it is conceivable that the US model could work in Australia. Moreover, in the US, that model has allowed the rail mode to compete very effectively with road, and to expand its share in recent years, despite significant road pricing distortions.

However, a major limitation to the viability of this approach in Australia is that Australia's rail freight densities are an order of magnitude lower than in the United States, meaning that Australia's rail operators are not commercially self-sustaining, other than in coal, iron ore and some selected bulk commodities. Further, and perhaps most importantly, the substantial and growing backlog of maintenance on the Victorian and NSW rail networks would need to be resolved before such an approach could be adopted. A particularly acute bottleneck, which gravely compromises the efficiency of Australia's rail system as a whole, is the Sydney metropolitan network. Resolving that bottleneck should be far more of a policy priority than it seems to be.

These difficulties are formidable. Addressing them is, I believe, at least as important to the future of freight transport as efficient road charging — which is not to downplay the significance of road charging, but to put it into perspective.

Conclusions

In conclusion, whether road charging is the major impediment to efficient modal choice in Australian transport remains controversial; but that does not mean that better road charging would not be highly worthwhile — it would. A move in that direction would be most effective if it was accompanied by some resolution of the long-term issues associated with the structure of our rail industry. Devising an institutional structure that can properly address these issues remains a very major challenge.

General discussion

The general discussion for the freight transport session focussed on four matters:

- the importance of CoAG in the reform process;
- institutional arrangements and future reform; and
- the implications of competitively neutral pricing.

The importance of CoAG

One participant said that it was very important that now transport was on the CoAG agenda (3 June 2005), we keep it alive and keep pushing it forward. He also commented that it is important to push forward with incentives to ensure delivery of reform initiatives and to keep the central agencies involved in the reform process.

Rod Sims commented that a problem which had emerged with earlier CoAG processes was that the Heads of Government made many decisions on particular sectors (including freight), thought that was sufficient, and so took little interest in implementation. While the NRTC has continued to push ahead with reform, many of its initiatives have been frustrated. This reinforces the point that cooperative federalism usually only works if you have a continuing and effective CoAG mechanism not only to develop reform agendas, but also to monitor their implementation.

Another participant suggested that the trick is to have an effective CoAG mechanism that goes beyond the next six months. The next phase of transport reform needs to go for three to five years and an NCP-type structure would offer an effective platform for keeping transport on the CoAG agenda.

Institutional arrangements

One participant asked the speakers to comment on the influence of institutional arrangements on freight transport reform.

Rod Sims indicated that getting the institutional arrangements right was important to progressing reform effectively. He noted that rail and road user charges are

currently set by different bodies, without adequate regard to the desirability of setting charges in a competitively neutral way. He preferred a single entity to be given responsibility for setting charges for the directly competing modes of transport. And, while acknowledging the complexity of setting these charges, he suggested that one set of trade-offs should apply to both sectors rather than completely different methodologies being used.

While Sims supported the NRTC having responsibility for rail regulation reform, he suggested that it would be more effective if it were made a regulator, rather than a consensus body (that is, that it actually had the power to put in place uniform regulation of road and rail). He was also of the view that, if the ACCC took responsibility for road as well as rail charging, and there was a national transport safety body, then the three institutions would be sufficient.

Tony Wilson noted that the States have the legislative coverage in road and rail transport so you need an institutional framework that recognises this while facilitating effective decision making to progress reform. One possibility was ceding certain powers to a body which is owned by all jurisdictions.

Implications of more competitively neutral pricing

There was some discussion about the extent to which the adoption of a more competitively neutral pricing structure would affect modal choice.

Rod Sims suggested that it would have a larger effect than most people think. While he observed that modal choice is 'not just about price', competitive neutrality would have knock-on effects to service levels and the quality of supporting infrastructure. Road user charges do not currently reflect efficient pricing considerations and, in effect, severely constrain or limit the prices which can be charged by rail. This has in turn given rise to underinvestment in infrastructure for rail.

Another participant noted that, when thinking about the implications of more competitively neutral pricing for modal choice, the issue of corridors is important. There was some discussion about Sydney's 'goat track' — the lack of a dedicated freight path. Freight trains are obliged to sit and wait for passenger trains to go through the network. Sims agreed that the proposed corridor strategies under AusLink could make a big difference to the service performance of rail relative to road. That said, the Australian Government considers the Sydney corridor issue to be a state problem, yet NSW has little incentive to fix the problem because it sees the benefits as mainly accruing at the national level.

Henry Ergas agreed that the corridor issues associated with metropolitan Sydney are of great significance to the competitiveness of rail on the east coast line. His view was that, if these issues are not addressed, one would have to be 'deeply pessimistic' about the long-term prospects for intermodal rail freight on the east coast. He acknowledged, however, that the difficulties involved in addressing these issues are 'enormous'. Also, the costs would be localised whilst the benefits would be largely national in scope. Better pricing would help, as it would involve significant congestion charges for freight moving within the metropolitan area and should induce some movement to put freight to terminal to avoid road transport congestion charges. That said, it would only help in part because the reality is that, within the major metropolitan areas, road and rail are not primarily substitutes but complements.

Tony Wilson observed that the present system for collecting road-use charges is a simple and efficient way of collecting revenue. Any shift towards direct user charges would have a degree of dead weight cost because of the greater administrative costs associated with developing better price signals. This raises all sorts of implementation issues about how to move from the current method of collecting road-use charges to another method. Wilson argued that in shifting from the present regime (flag fall and variable charge) to one which puts more emphasis on the variable charge, it was desirable to ensure that any alternative was relatively simple and practical.

Sims suggested that a different road pricing method would likely involve lower petrol taxes. Reforming freight charges clearly raised a number of 'whole of government-type issues' and would, in consequence, require intergovernmental collaboration to effectively pursue.

PART E

THE WAY FORWARD

10 The way forward

The final session of the roundtable harvested ideas from participants about useful ways of advancing productive reform in our federal system. It comprised a panel discussion, a general discussion and some concluding comments from Gary Banks.

10.1 The panel discussion

The panel discussion involved four participants — Geoffrey Brennan, Paul Kelly, John Langoulant and John Roskam — each reflecting in turn on key themes and issues to emerge from the earlier sessions.

Geoffrey Brennan

Australian National University

'Reform in the Federal System' is ambiguous between the idea of pursuing policy reform within the federal system, more or less as it stands — and reform of the federal system. I suspect that the title was crafted with this ambiguity in mind — with an intention to allow the discussion to range freely over both possibilities, as indeed it has.

Over the last two days, however, I have come to a firm conviction that the ambiguity was a mistake — that we need to maintain a sharp distinction between reform within and reform of institutions. Specifically, I think failure to maintain that distinction is hospitable to bad institutional design/reform. Approaching institutional questions via the policy agenda, as we naturally enough have done, encourages a kind of 'selection bias' in the sample of cases of policy proposals that we consider when we think about what particular institutions deliver.

Federalism is an institution in my sense — a sense that is, I believe, faithful to common usage in the 'economics of institutions' literature. That means, among other things, that it will be in place over a long period and have to deal with a variety of circumstances. In particular, it will have to deal with both good and bad policy proposals. Consequently, its capacity to inhibit bad proposals is no less significant a feature of an institutional arrangement than the capacity to accommodate good proposals. If I frame my questions about institutions in terms of

whether they are maximally hospitable to a policy agenda to which I am especially attached, then I 'frame' the issues in a way that tends to overlook its 'suppress the bad' role. And I think we have been susceptible to that framing problem in this roundtable.

Let me go back to the beginning of the roundtable. In his introductory remarks, Gary Banks posed the question as to whether our federal institutions are an obstacle to progress. The question is an entirely reasonable one, but it is somewhat under-specified. We need to draw a sharp distinction between whether our institutions are an obstacle to progress over the long haul, as distinct from whether they are an obstacle to progress in a particular instance. I fear that the way the roundtable has been framed has been perhaps excessively hospitable to the latter interpretation.

Suppose, for example, you were asked to give a paper of the following form. You begin by setting out your ideas about how some policy area should be reformed. You indicate where the current outcomes are poor and what might be done in policy terms to improve them. You then go on to ask: 'what are the main barriers to this particular set of reforms?' 'Would our current institutions — and our federal system in particular — be likely to get in the way?'

The answer is almost surely: yes! But I want to insist that this answer is not decisive. For an equally important question is whether our institutions inhibit *re*gress. And the answer to this latter question is unlikely to be entirely independent of the answer to the earlier one of whether institutions are an obstacle to progress. This is because many institutions operate by increasing the scrutiny that policy changes have to endure, and the number of persons/parties/interests that have to be consulted and won over. If that process is more likely to filter out bad policies than good ones, then the institution will be operating to the general benefit. It will make it more difficult to get good policy changes up, but only because it makes it difficult to get any policy changes up. The issue over the long haul is whether bad policies are more likely to be filtered out than good ones.

I say that this is the issue; but it is not an issue that is fore-grounded if one focuses attention on one's own pet policy proposals. It is not fore-grounded if the questions posed are framed by specific policy proposals that one sees as being highly desirable. The set of case studies would need to include instances where there were bad policy proposals that were implemented; and bad ones that failed to survive the processes of scrutiny. In short the whole sample of possibilities needs to be included.

Consider the policy proposals that have been initiated, from whatever source, over the course of the entire period in which federal structures have been in place. Or, if this is too long a horizon, consider just the last fifty years. It can hardly be

pretended that all those proposals have been good ones. We can almost certainly agree that lots of bad ones were implemented. It is probably a fortiori true if one looks as well at the ones that failed to survive the scrutiny process. Indeed, the primary reason why the benefits from policy reform as we now see it are so large is precisely because various kinds of 'policy mistakes' have been made in the past!

One might, of course, make the point that external circumstances have changed in such a way as to make the optimal policy mix very different now from what it has been in the past. Such an argument might be advanced in relation to certain kinds of environmental issues, for example, and Pincus does make mention of this possibility in his paper. However, to the extent that such an argument consists in pointing to the emergence of India and China as significant global threats, I confess I am unconvinced! I do not deny that the entry of significantly sized economies into the global trading nexus will impose transitional costs on all the players. As the division of labour becomes more refined, adjustments are required. But this is the primary engine of progress, not a threat to it — at least, if you think that Adam Smith's vision of the causes of the 'wealth of nations' was half-way correct.

As I see it, to examine institutions on the basis of their hospitality to a given vision of reform (a vision of which one approves) is a little like doing an econometric exercise on the basis of a sample of one. Moreover, the 'one' in question is not randomly selected: it is selected on the basis of a prior judgement that, whatever else, this policy is highly desirable!

Now, it might be thought that what I am arguing is a kind of 'conservatism' — either in policy design or in institutional evaluation. I think that would be a gross mischaracterisation. I am not arguing here that we should weight the sample towards the worse end. Nor am I appealing to something that I actually believe — that bad policies are likely to do more harm than good policies do good. As I say, these arguments are ones that might be made — and in my view deserve to be taken seriously. But that is not my point here! My point is not so much conservative as it is anti-idealist. Part of the contribution that economists make to policy debate is to remind people who might have forgotten that there are 'feasibility constraints' — that dreaming of ideal worlds where most of the constraints that dog the real world are set aside is dangerous for good policy!

I am simply repeating this message in the context of institutional analysis.

And I should emphasise that this is not a critique of the papers before us — as policy papers these have been engaging and informative and admirably modest and restrained. They have not oversold the likely gains from policy changes. Nor have they painted an unnecessarily dire picture of the status quo (as many reformers are prone to do). But the authors have examined institutional arrangements in a context

framed by what policy should ideally be. And that framing is prone, I reckon, to distort the picture. In other words, I thought the papers excellent to the extent that they were concerned with 'reform within the federal structure'; but frankly, rather dangerous to the extent that they were interpreted as providing evidence on 'reform of the federal structure'! I should add that I thought that both the Pincus and Walsh papers were extremely helpful in setting out some of the relevant arguments; but I also think that we changed gears appreciably once we began on the 'policy agenda' aspects. It is as if we were gathering data on the wrong hypothesis.

I should also emphasise that I do not necessarily see the argument for a 'complete sample' of cases as a defence of the institutional status quo. It may fall out that the arrangements that are embodied in our federal structures are, by and large, good ones. They certainly serve to increase the number of potential 'veto points' in the system, to use George Tsebelis's terminology (see, for example, Tsebelis 2002). And this means that there are more people who have to be persuaded of the benefits of the policy in question. More people who perhaps will have to be compensated for negative effects; but equally a larger number of potential 'rent-seekers' who may seek to 'sell' their support in the relevant forums. The constraints embodied in our federal system as it currently operates may be too weak, or too strong, or inappropriately located, or 'surplus to requirements' given other constraints operative in our political constitution.

My claim here is just that we have not done the work we need to do in order to decide on this range of issues.

Paul Kelly
The Australian

After the 3 June 2005 CoAG meeting, John Howard said it was the most cooperative and productive such meeting he had attended in nine years as Prime Minister. Queensland Premier, Peter Beattie said cooperative federalism was alive and well. Victorian Premier, Steve Bracks said it was the best meeting he had attended.

The question raised by these remarks is whether the June meeting was a false dawn or a new morning in cooperative federalism.

There was, I believe, a new political calculation at work among the leaders. This CoAG meeting followed a series of public spats between the Prime Minister and some Premiers that was counter-productive all round. There are several ingredients in this new calculation.

First, from the Australian Government perspective the nature of the reform agenda is moving further into areas that require federal-state joint decision making. Second, there are signs that some States have done a political re-think, notably Victoria, not the leading beneficiary of our more favourable terms of trade. Steve Bracks told me two months ago that 'Victoria's fortunes as a State are tied completely to the fortunes of the wider nation' and that he wanted a 'third wave of national reforms'. Such sentiments are also influenced by State Treasurer, John Brumby.

Third, leaders seem to be united on a particular electoral judgement – that there is no political dividend these days in the Australian ritual of buck-passing and blame-passing between the States and the Australian Government. I suspect this is reflected in party research showing that the public cannot stand it; tolerance for buck-passing is on a short fuse. Fourth, this is a time for incumbency and the authority of the Prime Minister is an ingredient in this mood. The Premiers feel that good politics dictates cooperation with Canberra and not confrontation. After all, they know that a significant minority votes for Howard at federal elections and then for the ALP premier at State elections.

Fifth, there was a willingness at the June CoAG meeting to manage and contain Liberal-Labor differences and not to allow these differences, for example over industrial relations, to define federal-state relations. The industrial relations debate at that meeting was extremely brief and businesslike. The Premiers declined to refer their powers on industrial relations and everybody went to the next agenda item. There is an element of the ritualistic about the State opposition to the industrial laws. Sixth, there is some evidence of public service influence in shaping the more cooperative climate, witness the role of Peter Shergold in Canberra and senior Victoria public servants working for Bracks and Brumby. The bureaucrats want to organise better outcomes and they are having an impact.

At this point I want to say a few things about John Howard's attitude towards federalism. Like most of Howard's attitudes it is more complex than appreciated.

Pivotal to Howard's governance is his abandonment of the Liberal Party's genuflection before the altar of State powers. Howard is less committed than Robert Menzies or Malcolm Fraser to balance within the federal system as an objective in its own right. There are no significant State Liberal leaders to try to impose this restraint upon him. It is a reminder that Howard is less interested in the theory of governing models and more interested in practical outcomes. He sees federalism not as an end in itself, but more as a means to an end — and this is probably healthy.

Howard rejects Health Minister Tony Abbott's ambition to take over public hospitals. He pioneers a new uniform industrial system in an act of Australian

Government assertion. And he agreed in 1998 to give all the GST revenue to the States. The consistency in these inconsistencies is politics not ideology.

In justifying the industrial changes Howard invokes the Liberal philosophy of individual freedom thereby transcending the federalism debate entirely. He invokes a more important principle, saying, 'the goal is to free the individual, not to trample on the States'. It is a neat re-arrangement of Liberal principles — the individual is more important than the States. This mirrors Howard's guiding star that federalism must be judged according to how it delivers 'better lives for people'. He has neither Whitlam's commitment to centralisation nor the traditional Liberal commitment to State powers.

He thinks the States have squandered much of their opportunities from the long growth cycle and have been far too reluctant to pursue productivity-raising reforms, pandering instead to their Labor constituencies and trade union interests. Howard's preference is economic reform via national markets from energy to transport.

Howard listens to the people and has absorbed their message — he knows that State loyalties are fading and that national loyalty is growing. He is fascinated by the rise of national spirit and what he calls the nationalisation of our society. He sees this shift at an institutional level remarking that when he was a young solicitor in Sydney in the early-1960s, legal firms were confined exclusively to State capitals with Sydney firms having Victorian agents in Melbourne, the relic of a lost age. Howard's nationalism is powerful and pedantic. When attending State of Origin Rugby League matches he refuses to barrack for NSW. On talkback radio and travelling the country Howard finds that people think national; the media focus is national; when issues are discussed people look to the national government, not state governments for solutions. And this is the reaction from rural and regional Australia.

As a political and economic opportunist Howard sees the chance to extract more from CoAG than he did before. A lot of the June meeting involved the commissioning of inquiries and those inquiries are about to come to fruition. I suspect any progress will be measured. Howard himself is ambivalent about National Competition Policy (NCP) and has been prepared to exempt his own support groups. While I mentioned earlier the political factors encouraging cooperation there are also political limitations on reform. The benefits from reform are more diffuse than ever. The costs are front-end loaded and the benefits are a long burn. The Labor Premiers will invoke the original NCP framework and say financial incentives will be vital to any new agenda. They argue the Australian Government is the winner from higher tax revenues that flow from reforms and such dividends need to be spread to the States. The Howard Government has shown its scepticism about backing NCP with fiscal clout. However, the Australian

Government will have to re-address this issue and the States will interpret this as a test of the Australian Government's faith. It will also be a test of Treasurer Costello's interest in cooperative federalism and another round of economic reform in tandem with the States.

The obstacles lie in lack of policy agreement (over areas such as health), the polarisation over the industrial issue actually infecting the wider reform process and differences over financial compensation.

As we approach the end of 2005 there are signs of optimism about the CoAG meeting next year. If there is a new spirit of cooperative federalism then the alignment of the Coalition in Canberra and Labor in the State capitals should become an advantage. This is because it makes both major parties stakeholders in the process.

John Langoulant
Chamber of Commerce and Industry WA

I think I will give a slightly different dimension to this, but picking up on the theme of Paul's comments I actually thought about what would a West Australian have said at a roundtable like this in a house like this many years ago. He probably would have said the way forward for federalism is secession. Indeed, even though there are still some in Western Australia who look alluringly at the riches of the resources boom and say perhaps secession is an option, they are in, I am pleased to be able to say, a very very small minority. Nevertheless, the issue of buck passing and blame shifting between the Australian Government and the State is still good political sport in the West.

But I am pleased to be able to say at the same time, and picking up Paul's theme, that the vast majority of people in the West — and what I have sensed from this room — is that we are all here looking for national outcomes. National outcomes in terms of the federation, I think, need to be a goal which underpin how we do move forward. The last day and a half, I must say — even though I have been involved in federal-state matters for the best part of the last 20-odd years — underlined for me the degree of complexity which is now in the arrangements.

Of the three case examples we looked at, the pervasiveness of the Australian Government involvement in areas of activities which for the most part were State responsibilities, other than for industrial relations, is extraordinarily striking. Competitive federalism, I think, and cooperative federalism are both alive and well in different dimensions of the issues we have looked at. I must say I am a strong believer in cooperative federalism. I think it is through cooperative approaches that

you get stronger and more enduring outcomes. But competitive federalism clearly does have a role to play and to me the most beneficial role is through yardstick competition.

But I also agree with the observation Ken Henry made last night, that cooperative federalism from time to time can give rise to more conservative outcomes than might otherwise be desirable. With my new role in terms of looking at business interests, I might say that business, in looking at federation issues, is probably more confused than anything when they try to understand how service delivery operates across Australia between levels of government, and how regulatory activity gets formed and implemented (and whether it is in their best interest).

The degree of noise which is around both those areas, service delivery and regulatory behaviour — the noise being the political noise of accountability shifting, buck passing, call it what you like — only gives rise to a conclusion, I think, that business takes, and probably most in the community, that things are not well in our federal arrangements. Increasingly, as business has to operate in a globalised marketplace and with emerging markets the size of China and India which stand with a competitive sword hanging over Australia, you have to think that perhaps there is a better structure of federal-state relationships which will enhance competition.

I draw on particular examples which we spoke a little bit about yesterday concerning industrial relations and regulatory activities, but I would extend it immediately into other areas like occupational safety and health, and workers' compensation. The tax systems that the States run where there is such differentiation in administrative arrangements across Australia, where corporations are having to endure six or eight different systems in terms of administrative arrangement, just adds to their cost. Some of these aspects of the federation I think need to be seriously thought through.

There are two dimensions I just wanted to deal with in the short 10 minutes I have about the last two days. One is how do we bring about the next phase of major reform to the extent that it can be achieved in our federal arrangements? We have discussed three case examples, and as I mentioned, they all have their complexities and they all have their challenges. We could have discussed many more. The one next high on my agenda would have been education and training where there are huge productivity benefits to be gained, particularly in the training area.

In looking forward, the common theme in terms of what is the best model for productivity reform in this area has been almost from every speaker the NCP arrangements introduced in the mid-1990s, and which for the most part delivered significant reform across the areas of activity that formed that policy agenda. As

Ken mentioned last night, we probably could have done things better, but at the time the NCP was introduced it was seen as being path-breaking reform. The difficulty of replicating it, of course, is that the circumstances that gave rise to the NCP are almost totally unlikely to emerge again.

Indeed, the strong level of leadership — to pick up the point Paul was just making about the embracement of NCP — at the federal level, I think is questionable. And other than perhaps across one or two States, the strong level of leadership — both at the political and bureaucratic level — really needs to be challenged if we are to see a new zeal for competition reform occurring. But it is not a bad model. If we could replicate it, I think it would be a step forward. It is not a bad model because it had an accountability aspect to it. Say what you like about the National Competition Council, at the end of the day it delivered substantial reform.

I think one of the great issues which would need to be addressed in another model of NCP reform is the sharing of the financial benefit that comes from the reform. The Australian Government's decision to terminate the compensation arrangements which were associated with the first round of reform, was, I think, a regrettable situation in terms of the development of trust — but nevertheless it is there. This issue of compensation was alive and well last night I noticed and it will need to be addressed very clearly if there is to be another round of reform. I might say that if it is not holistic reform then we will probably see a reform structure pursued on an individual policy area, such as health, for instance, or land transport, or indeed education and training. That structure, I believe, is the one which we should seek to pursue and establish the same institutional arrangements around it.

Secondly, I would just like to touch briefly on — because it generated such spirited debate on the first day — the current arrangements in federal-state finances. I must say, looking in on current arrangements, that the current structure of State finances is not sustainable. It may well endure for the next several years, but over the long haul it is unlikely to be with us. Vertical fiscal imbalance is high and, in some respects, that is okay because we now have GST being raised at the national level. The difficulty, I think, for the current arrangements is the nature in which the tied grants are developing, and over the horizon I would suggest to you that the GST will not remain condition-free — it will indeed become 'a fag with a tag', to draw on a past analogy.

The difficulty with tied grants are the conditions which are associated with them — they are limiting in terms of State policy flexibility. One of the points I recall from Ross Garnaut at the end of his talk is that through the nature of the tied grants, and handing a lot more responsibility and power to, what I would call, the line agencies, it dilutes the influence of central agencies to be able to effect real policy reform. That has been clearly my experience from running a treasury for the best part of 10

years. Whenever we wanted to implement sector-wide reform, invariably we would have a number of agencies come in to our process and say, you cannot touch us, because our funding is tied with the Australian Government and if there is any reduction in our effort we will lose all of the federal grants. That undermines autonomy of State Governments. It undermines, I think, the effort that is put in to reform across those sectors.

To be a little more provocative, I would say that we will need to look again at the structure of taxing powers at the State level. At the time the GST was introduced, the alternative option was to give the States a share of the income tax base. I would say it is a matter of time before that option is on the table again. It will provide an opportunity for the States to reform their taxes further — which I might say from a business perspective would be a high priority — and it also gives the States an opportunity, a further opportunity, of sharing in the reform program in terms of having a tax base which captures the benefits of the reform.

Finally, I was particularly taken by the discussion we had on freight transport about the significance of having more frequent CoAG meetings. I think in terms of looking forward in reform, frequency of CoAG meetings is essential if we are to get momentum into our reform activities. I guess I am encouraged in terms of Paul's comments in that regard that perhaps the Prime Minister might be warming to that process.

John Roskam
Institute of Public Affairs

The past two days have provided an excellent opportunity to consider the strengths of Australia's federal system, and how that system can continue to provide a framework for further economic and public policy reform. In this context my remarks will come under three headings:

- the nature of federalism;
- the nature of the issues confronting Australia; and
- the impact of globalisation and its relationship to federalism.

The nature of federalism

A comment that has been made about the discussion on school funding in Australia could also be applied to the topic of our current considerations — debate on federal-state relations is like a Russian novel '... long, tedious, and everybody dies at the end'.

The statement was made earlier at this roundtable that anyone involved in public policy in Australia will undoubtedly need to consider the issue of federalism. Nothing could be more true. That is a little like saying that anyone wishing to play cricket will sooner or later come up against the need to have a bat and a ball.

The point about federalism in Australia is that it is believed in theory but ignored in practice. The arguments for federalism are well-known and I do not propose to list them.

However, sometimes familiarity with the propositions can breed contempt. We cannot consider federalism in the abstract — in 2005 we need to ask the question, what do we want federalism to do?

This question must be considered within a broader framework of what should be our policy objectives: 'equity', 'economic development', 'sustainability'? All these objectives are laudable but they are in conflict and they involve making policy choices. Politicians and the public do not usually like to admit that there must be tradeoffs. Australia could have an even lower unemployment rate than it has now if we were willing to reduce real wages, but to many the equity consequences of this would be an unacceptable trade-off.

Federalism and equality

For much of the last century policy pressures actually mitigated against federalism. Certainly the States had more financial and policy autonomy than they do now, but overwhelmingly the desire was to equalise economic and material conditions across the nation. 'Equality' was relatively easily measured, and we had a tendency not to be much interested in the cost.

There is still the legacy of such attitudes in the debate about telecommunications for example. Those who live in remote areas expect the same level of telephone service as those living in inner-city Sydney. Usually policy-makers have acceded to such demands. The transfer of wealth to non-urban areas from urban areas, and to small States from large States has long been, broadly, accepted. Ideas of 'federalism' have not had much to do with this process. To a large extent the national government has operated as the mechanism for initiating the transfer of wealth. Occasionally national governments have acted in the name of 'national interests' as, for example, when it promoted population and land settlement policies for defence purposes, but often they have operated on the assumption that circumstances across the country should be 'equal'. The notion of federalism, as a system in which levels of government operated in different spheres of policy, was compromised in this country from the very start.

Instead of calls for ‘equality’ we have now in the twenty-first century demands for ‘efficiency’ and ‘national markets’. Critics of a federal system cite the need for ‘efficiency’ and ‘national markets’ as one of the reasons why the overlap and duplication of state jurisdictions should be abolished, and why regulation should be centralised. While it is true that further economic reform does require some degree of administrative clarity, such administrative clarity only needs to exist in the markets for products that are traded on a global basis.

Reform to the regulation of such products is only one-half of the reform challenge confronting Australia. There is a significant reform challenge in many areas of government activity for which no market exists, such as in areas of social policy, and in such realms it is not necessary or desirable to streamline every aspect of regulation, if such a process results in a reduction of diversity in the way services are offered to the community.

In the debate about efficiency of regulation the states are automatically taken to be the ‘bad guys’, holding out against reform in the name of petty-minded parochialism, while the national government are the ‘good guys’ fearlessly pursuing reform against the entrenched self-interest of rent-seekers. Such a picture probably has more to do with the superior media management techniques of Australian Government press secretaries than with reality.

Federal Governments are no less effective at pandering to self-interest than are State Governments. Recent decisions on the regulation of pharmacies, the electronic media, and international air transport are examples of this. And this is not to mention the matter of tariff protection. The policies of protection pursued by Federal Governments (of both political persuasions) have had a far more deleterious effect on the economic welfare of the nation than any economic policy ever pursued by a State Government.

There is one respect in which Federal Governments *are* better placed than State Governments to pursue reform. The political pressure points of Federal Governments are different from those at the State level, and reform which impacts on, for example, public sector employment can be more easily pursued by a government in Canberra, than by one in a State capital. There is a sense in which the political (and geographical) isolation of Federal Governments is an advantage.

Federalism and simplicity

The desire to ‘reform’ and make regulation ‘simple’ is perfectly understandable. And sometimes the solution to a problem *is* simple — but often it is not. The claim that providing the Australian Government with regulatory powers over areas which

were previously the province of the States is sometimes made. However, as has been discussed at this roundtable, the track record of the Australian Government in relation to 'simplicity' is mixed — income tax, industrial relations, the regulation of financial services and superannuation are all the responsibility of the Australian Government, and the laws governing these areas are not particularly simple.

Wasteful competition

In the course of the roundtable a number of remarks have been uttered about federalism resulting in 'wasteful competition'.

My view is that competition is seldom 'wasteful' — and anyway we have to define what we mean by 'wasteful'. Certainly in one sense it is 'wasteful' that we have more than one television channel — but the existence of 'waste' must be matched against the benefits of choice and diversity. Competition, by its very nature, involves 'waste'. As an argument against federalism, 'waste' is not strong. It may be wasteful for each State and Territory to have its own school curriculum, and indeed this is one of the arguments for a 'national curriculum'. Few proponents of a national curriculum, however, pause to consider the practical consequences

The example of 'wasteful' competition provided to the roundtable was that of State Governments offering subsidies and inducements for industries to locate in their State. Whether this is 'wasteful' is extremely debatable. Given that States have so little capacity and so few means to compete against each other for inward investment it is perfectly understandable that State Governments will resort to using one of the few mechanisms they have left to them to attract business. Subsidies might be legitimately criticised as a means of economic policy, but this has nothing to do with federalism.

The nature of the issues confronting Australia

In the 1980s the economic policy challenges had answers that were more clearly defined than are the challenges we currently face. The term used during this roundtable to describe today's challenges was 'vexed'. The issues of the interface between economic and social policy are not obvious. As Andrew Podger identified in his paper, there is an intimate relationship between education, health, and welfare issues, and they cross traditional portfolio boundaries. It is unlikely that there will be one single 'answer' to the problems of the future.

Discussions of social policy will inevitably involve all three levels of government — a 'one size fits all' model across the country to, for example, improve indigenous employment outcomes will be inappropriate. State and Local Governments will

have varying areas and levels of expertise, and only a federal system can provide solutions that take advantage of these differences.

The impact of globalisation and its relationship to federalism

The impact of globalisation on the Australian economy and on national politics is yet to be fully appreciated. However, one consequence that is already apparent is the different rates of economic development of our States and regions. Western Australia, for example, with its energy and mineral resources and its exposure to Asia is a State whose economy is rapidly 'internationalising'. On the other hand, the economy of South Australia is not. In Queensland, when one talks of China the word 'opportunity' comes to mind, while in Victoria because of its manufacturing industries, China is more often associated with the threat of job losses.

All of this demonstrates the need for the application of different sorts of policies according to individual circumstances. The capacity of States and regions to respond to fiscal challenges is obviously hampered by the existence of a single national currency. The point has often been made that if during the 1980s Victoria had had its own freely floating currency the worst depths of the recession in that State might have been avoided. This is not to argue for such a policy, but simply to recognise the costs and benefits of single national systems.

If Australia is to take advantage of the opportunities that globalisation provides all levels of government must be able to respond with policies that take account of the differences between States and regions — and only a federal system allows this to occur.

10.2 General discussion

The general discussion covered a range of issues that had been raised over the course of the roundtable, but two major themes emerged:

- aspects of cooperative and competitive federalism; and
- the significance of reform outcomes and dividends.

Cooperative and competitive federalism

In drawing lessons from the roundtable, several participants emphasised the benefits of cooperative federalism and its potential to facilitate reform that would materially improve national productivity and Australia's growth performance. In this regard, a particular aspect of cooperation between governments stressed was the need for

frequent high-level meetings. For example, one participant argued that a necessary condition of a federal system working well was regular meetings of Heads of Government — adding that, while there were differences around the room about many aspects of federalism, there was unlikely to be disagreement on the necessity of having regular forums for discussion, whatever the outcomes. Failure to do so just hobbles the entire Australian economy.

Another participant noted that it was important for Heads of Government to see their task as ongoing, rather than episodic (when 'the stars were aligned'). Once high-level agreement was achieved, specialist bodies or key agencies could work out the detail.

There was also some debate about intergovernmental cooperation and the use of special purpose payments (SPPs). One participant recalled the previous day's discussion on this subject and observed that, once SPPs are in place, linkages are built between national and state agencies — whether in health, education or other areas. Accordingly, SPPs could be regarded as a form of cooperative federalism (even if they are sometimes the result of coercive behaviour). However, another participant disagreed, arguing there was no economic logic to SPPs and that most were purely exercises of political power by the Australian Government. This could be seen clearly in areas such as schools, regional roads and local government. Both participants agreed that the current use of SPPs was unlikely to be in the best interests of the States or the nation.

This issue also arose in a discussion of whether health reform could be best achieved by cooperative or competitive federalism. One participant expressed some sympathy with SPPs being seen as a form of cooperative federalism, but noted that if the chosen path on health reform meant a totally cooperative arrangement, this would result in a huge SPP with all the States locked into it in a major way — and not just this year, but well into the future. This would not necessarily be desirable. The participant added that, at some point, cooperative federalism issues get too hard, particularly the big social policy areas. Accordingly, it may be better in these large areas to opt for competitive arrangements instead, with most States and Territories learning from the policy innovations of 'leading edge' governments.

Competitive federalism as a path to productive reform was also discussed with respect to 'picking winners' and destructive competition. One participant noted a possible conundrum of selecting inappropriate institutional arrangements to achieve the right policy outcome. While the States are most valuable in the federal system because they compete, they have cooperated to restrict the use of selective assistance to attract investment. Although this is generally regarded as a favourable outcome, does this justify the 'collusion' amongst the States to achieve it? In response, another participant said that cooperation amongst States to prevent

competition was only applicable (and acceptable) in very specific cases, adding that there is general approval of States competing by having better infrastructure, a better skill mix, a better tax structure and the like.

Reform outcomes and dividends

Two participants emphasised the importance of reform outcomes and dividends. The first said that if Australia is to achieve further reforms, and in particular health reform, the expected dividend in terms of reform outcomes had to be outlined up front. The papers presented at the roundtable on health very clearly identified some of those areas where better outcomes are required — for example, indigenous health, preventive programs and primary care programs. Those proposed outcomes need to be made absolutely clear and, to the extent possible, quantified.

The other participant argued that, as with NCP, there is a need to 'measure' reform objectives, and to have milestones and monitoring processes. The same participant claimed that gain-sharing was one of the most fundamental aspects of the NCP reforms. The fact that the Australian Government was prepared to forego a significant proportion of its prospective fiscal dividend was said to be a good outcome, and the appropriate characterisation of this process is 'reward sharing' rather than 'bribing'. In this context, the same participant lamented the fact that the Australian Government had unilaterally 'pulled the plug' on this very important reform lubricant when there was still more to do.

Another participant questioned the need for such an incentive by pointing to the benefits that the States get from undertaking reform in the form of economic and social dividends.

10.3 Further comments by the panellists

The four panellists were invited to make further comments in response to points raised in the general discussion.

Geoffrey Brennan

Geoffrey Brennan took up the issue that achieving good policy outcomes could sometimes be at the cost of good institutional arrangements. He cautioned about being blinded by the immediate policy outcome and advocated the need to look over a longer horizon to consider the 'bad things' that policymakers with quite different agendas might do if they were to secure power. In addition, he drew attention to the

importance of the processes by which policy decisions are made, and the sense that all relevant parties have of being properly consulted. For example, some people are not just concerned when they go to court that they win the case — if they have their day in court, and if they feel that they have been treated fairly, then they value that experience intrinsically. He thought that this might be true more generally.

Brennan questioned the notion advanced by some participants that globalisation — and particularly the emergence of India and China — was a threat, rather than an opportunity. He feared that people with reform agendas, even agendas of which he would approve, would use a sort of 'crisis rhetoric' to make it more likely that the general atmosphere would be conducive to getting those reforms implemented.

Paul Kelly

Paul Kelly maintained that 'everything comes from the political framework' and there was a sense at the moment of an opportunity for reform via a new approach, a cooperative federalism. However, the situation is fragile and it depends on political will and the leaders across the Australian Government and the States identifying a common political ground and recognising the associated benefits. He thought that the States recognised the need to become more proactive and that they could not operate for ever just taking the benefits of revenue growth and marking time. In his view, there are fundamental problems starting to emerge at a State level which will have serious repercussions for their political leaders if they are not addressed.

He also suggested that an important challenge for the Australian Government over the next few years — as the reform agenda of the last decade or so is completed — will be the extent to which a new ideology of reform can be constructed within the coalition parties which provides a 'guiding star' that the politicians and the supporters can understand. A key question is whether cooperative federalism will be an element of the process.

John Langoulant

John Langoulant made three comments. First, that the quantification of the benefits from reform, whether by cash or as a package, is absolutely essential to obtain broad community support for future reforms. Second, that SPPs (and other aspects of federalism arrangements) should be more focused on outcomes and provide greater flexibility, allowing the States to determine program activity to achieve certain outcomes. Third, that the changing nature of the Australian economy, increasing competitiveness and the changing way we interact with the world

economy, means that the role of the States, in particular, has changed to a point where a review of roles and responsibilities would be timely.

John Roskam

The first of four points John Roskam made was to agree on the importance of high-level meetings, but to contend that the sorts of meetings that need to occur — and which would be incredibly valuable — should involve ministers only. Secondly, he argued it was important to accept that there may sometimes be adverse consequences of competition between governments, but they all can learn from these outcomes. Thirdly, he observed how difficult it is to quantify the benefits of reform, particularly in areas like education where devolution or curriculum reform may take 20 years or so to bear fruit. His final point was to agree with Paul Kelly about the ideology of reform and that the challenge of ensuring that the new agenda falls onto fertile ground. In this regard he said it would be difficult to establish NCP 'Mark II' without any of the reform agenda or 'crisis' that characterised the need for the original NCP, and without the benefits being identified.

10.4 Concluding comments

In closing the roundtable, Gary Banks observed that while Australia had come a long way in meeting reform challenges, there was clearly a shared sense that we needed to do better. He believed that Australia's federal structure should be part of the reform solution, with a role for both cooperative and competitive approaches. Getting the mix and focus of these two approaches right is the challenge we now face.

Banks emphasised that there was currently a rare window of opportunity for CoAG to develop and commit to follow-up reforms to the NCP. It was vitally important that Heads of Government provided the leadership for the next phase of reform, as had been instrumental with NCP during the 1990s. However, in some respects the forward agenda is more subtle and complex than NCP, and the potential gains less self-evident. Heads of Government would have to be convinced that it was worthwhile to press ahead with further reforms, given the inevitable short-term difficulties and costs involved. In this regard, it was incumbent upon central agencies in Federal and State/Territory Governments to provide CoAG with information to galvanise support for further reform.

At the same time, Banks judged that there was a continuing need for productive competition among jurisdictions. In the longer term, institutions will determine our future and it is important that they are creative and innovative, as well as being able

to respond to challenges. Having an opportunity for localised policy experimentation is an important aspect of this role and is a strength of our federal system.

He also noted that the Commission would continue to assist in providing a broad understanding of the rationale for and consequences of reform and stood ready to assist both the Australian Government and governments collectively through CoAG.

Finally, on behalf of the Productivity Commission, he thanked participants, particularly those who prepared papers for the roundtable.

PART F

DINNER SPEECH

11 Time to 'get real' on national productivity reform

Edited version of Dinner Speech — Ken Henry
Secretary to the Treasury

The most recent OECD Economic Survey of Australia, published in February of this year, commences with this paragraph:

> In the last decade of the 20th century, Australia became a model for other OECD countries in two respects: first, the tenacity and thoroughness with which deep structural reforms were proposed, discussed, legislated, implemented and followed-up in virtually all markets, creating a deep-seated 'competition culture'; and second, the adoption of fiscal and monetary frameworks that emphasised transparency and accountability and established stability-oriented macro policies as a constant largely protected from political debate. Together, these structural and macro policy anchors conferred an enviable degree of resilience and flexibility on the Australian economy. The combination resulted in a prolonged period of good economic performance that shrugged off crises in its main trading partners as well as a devastating drought at home. The short-term outlook is for continuing strong growth of productivity and output, low inflation and budget surpluses accompanied by tax cuts. (OECD 2005, p. 11)

Following the August 29, 2005 Article IV review of Australia, the Executive Board of the International Monetary Fund had this to say:

> Executive Directors commended the authorities for the sustained strength of Australia's economic performance, which they attributed to an exemplary setting of economic policies and institutions, supported by broad consensus on many issues. This includes wide-ranging structural reforms implemented over the past two decades, along with a prudent and flexible management of monetary and fiscal policies within transparent medium-term policy frameworks that has helped enhance the resilience of the economy. (IMF 2005b, p. 2)

In Paris and Washington, Australia is the model economy. Our policy frameworks set the standard for other industrialised countries. And, in terms of macroeconomic outcomes, the recent performance is, indeed, impressive. We are now in our 15th year of growth, averaging 3.6 per cent a year. We avoided fall-out from the 1997-98 Asian financial crises and the world recession of 2001. Among industrialised

countries, our average growth rate over the period from 1990 was exceeded by Ireland and Luxembourg only. The unemployment rate is at a low 5 per cent. Inflation has been well behaved for many years now.

Over the last 15 years our average GDP per capita growth rate has exceeded that of the United States by almost one-half of a percentage point a year, and we have exceeded the OECD average growth rate by two-thirds of a percentage point a year.

Those 'economic rationalists' who tirelessly argued the case for economic reform might consider that they have much to celebrate. But celebration could be premature.

Read the OECD report closely and you will find passages like the following:

> ... although Australia's per capita GDP relative to that of the United States improved by 6 percentage points from 1990 to 2002, to 76 per cent of the US per capita GDP, this only restored Australia's relative position held in the 1970s and falls short of where it was in 1950. (OECD 2005, p. 30)

Should we celebrate a GDP per capita level that is only three-quarters that of the United States, particularly since recent productivity growth has been stronger in the United States and, over coming years, we will feel a more severe impact of population ageing on workforce participation levels?

When I was growing up, I knew that the average American had a substantially higher income than the average Australian. I thought the gap was due to our having a healthier appetite for recreational pursuits. This was not a major policy problem: if Americans wanted to work while we were surfing, that was their choice.

But this perspective turns out to be based on a myth. While cyclical factors make point-in-time comparisons difficult, the proportions of the Australian and American populations that are employed are little different, and, today, Australian employees work almost as many hours as their American counterparts.[1] Among OECD economies, the only ones that exhibit significantly higher hours of work per capita are Iceland, Korea and Luxembourg.

We have lower average incomes than the Americans not principally because we work less, but because our productivity is significantly lower. Our average incomes are lower because our work is worth less — and not just less than in the United States. In OECD rankings of GDP per hour worked we are to be found in the middle of the pack (OECD 2005, p. 31).

[1] The United States recession in 2001 was responsible for a significant narrowing of a gap that had persisted throughout the 1990s.

Of course, a statement that our work is worth less does not imply that our workers are in any sense inferior. Differences in labour productivity are, usually, due to things other than the innate characteristics of workers.

Recent work published in the *Treasury Economic Roundup* (Rahman 2005) finds that the Australia-United States productivity gap can largely be explained by differences in geography, human capital, and product and labour market policies. Differences in physical capital per worker — that is, capital deepening — and industry structures do not appear to be important.

Australia's remoteness from the world economy's 'centre of gravity' and the geographic dispersion of our population has implications for scale economies, the intensity of competition and transport costs. All of these things affect productivity. Remoteness alone could account for as much as 40 per cent of the productivity gap with the United States (Battersby 2005).

There is a limit to what we can do about remoteness — although it is worth noting that the development of China and India is bringing the world economy closer to us.[2]

Just as obviously, there are limits on our ability to reduce the geographic dispersion of population settlement on the Australian continent. These limits are not new. And neither is an acknowledgement by policy makers of their economic significance. They were at the forefront of people's minds pre-federation.

Section 92 of our nation's Constitution commences with the following sentence:

> On the imposition of uniform duties of customs, trade, commerce, and intercourse among the States, whether by means of internal carriage or ocean navigation, shall be absolutely free.

According to the 3rd edition of *Sawer's The Australian Constitution* (Aitkin and Orr 2002, p. 33), one of the main reasons the Australian people supported federation was the desire to have a single trade area throughout Australia. Section 92 is one of the key 'common market' provisions in the Constitution.[3]

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2 Recent Treasury work estimates that the proportion of world GDP within 12 000 kilometres of Sydney increased from about 26 per cent to nearly 38 per cent between the 1950s and the 1990s (see Ewing and Battersby 2005).

3 The other 'common market' provisions require uniform custom duties (section 88); prohibit the states from imposing duties of customs and excise or granting bounties on production or export (section 90); prohibit the Commonwealth from discriminating between the States or parts of States in respect of taxation (section 51(ii)); require any bounties to be uniform throughout the Commonwealth (section 51(iii)); and prohibit the Commonwealth from giving preference between the States or parts of States in respect of trade, commerce or revenue laws generally (section 99).

With its insistence that interstate trade, commerce and intercourse be 'absolutely free', it looks like the sort of thing that an economist would write. The legal system can have trouble with such imprecise language. It was not until the 1988 case of *Cole v Whitfield* — more than three-quarters of a century into the federation — that we finally got a unanimous High Court interpretation of the words 'absolutely free'. According to *Sawer's The Australian Constitution*, as a result of that case:

> It now seems settled that section 92 prohibits action by either the Commonwealth or a State which discriminates against *inter*state trade or commerce and which has the purpose or effect of protecting the *intra*state trade or commerce of a State against competition from other States. (Aitkin and Orr 2002, p. 33)

This judicial interpretation of section 92 follows the construction of the other 'common market' sections of the Constitution in its reliance on *pro*scription.

These various constitutional prohibitions fall well short of ensuring nationally uniform laws affecting economic activity — except in narrowly defined areas.

More generally, none of the Constitution's so-called 'common market' provisions compels the States to do anything at all to facilitate the development of national markets in anything — no good, no service, whether a business input or a household purchase.

We do not have a national labour market. Of course, a predominance of state-based industrial relations systems explains some of that. But so, too, do state-based systems for occupational health and safety and occupational licensing. Consider, for example, the case of electricians, where 'mutual recognition' legislation is in place. If an electrician is licensed in one jurisdiction in Australia or New Zealand, they can then apply to become licensed in another jurisdiction, after making application and paying a suitable fee to the licensing body in that jurisdiction. But there is a problem: how does one jurisdiction know what an electrician from another jurisdiction looks like? It turns out that the word 'electrician' means different things in different jurisdictions. There are different categories, and numbers of categories, across jurisdictions that act as a substantial barrier to transferability.

Or consider hairdressers. The qualification, 'Certificate III Hairdressing WRH30100', is nationally recognized. But what does that mean? Well, it does *not* mean that somebody will be considered 'qualified to work' in a jurisdiction simply because he or she has a certificate. Different jurisdictions have different pathways — generally involving different work experience requirements — to progress from the certificate to being considered 'qualified to work'. As a consequence, we do not have a national market in hairdressing services.

Electricians and hairdressers are but two examples out of hundreds.

We do not have a national electricity market, even though we launched something with that name in 1998. Instead, there is still a regional approach to many key regulatory and network planning decisions. In saying this, I do not want to understate the importance of reforms to date. But I do want to highlight the problem of disparate state-based regulation of energy distribution networks, retail businesses and retail pricing. State retail price regulations, in particular, distort price signals to both consumers and investors.

We do not have a national water market. In fact, we do not even have functioning State water markets. Instead, the majority of trade in water occurs within catchments and even then in insignificant volumes. For example, trade in permanent entitlements in the southern Murray Darling Basin involves, on average, only 1-2 per cent of total allocations, and water still cannot be traded interstate beyond a limited pilot area. Moreover, water is rarely traded between competing uses, being more likely to be traded between producers of similar commodities.

The National Water Initiative (NWI), agreed by CoAG in June 2004, sets out to establish a property rights framework for water and to create a national water market. The obstacles are considerable. For example, States have different water entitlement regimes, which create a practical barrier to the development of a national market. These barriers have proved difficult to overcome. But unless and until they are, NWI benchmarks will not be met.

We do not have national markets in land transport — neither road nor rail. Instead, an operator of an interstate train in Australia may have to deal with six access regulators, seven rail safety regulators with nine different pieces of legislation, three transport accident investigators, 15 pieces of legislation covering occupational health and safety of rail operations, and 75 pieces of legislation with powers over environmental management. Australia has seven rail safety regulators for a population of around 20 million people. In contrast, the United States, with a population of 285 million people, has one rail safety regulator.

A particularly farcical example of rail services fragmentation is in train communications. Currently, each State and Territory requires trains within its jurisdiction to have a particular type of radio — for good measure, NSW mandates two — meaning that a train cannot operate nationally without eight different radio systems. And even with a cabin full of eight radios, trains cannot ‘talk’ to each other.

The situation is better in road transport, as a result of cooperative efforts since 1991 through the National Transport Commission. But those cooperative efforts have not produced consistent national road transport regulation.

These are but a few examples, illustrative of a lack of national markets for business inputs. They are not atypical examples. Indeed, it may not be too much of an exaggeration to say that the only significant business inputs for which we do have national markets are financial capital, post, telecommunications and aviation.

Yet the case for governments facilitating the development of highly efficient national markets for key business inputs in a country as remote and geographically fragmented as ours is overwhelming.

Why has it not happened? Part of the answer — the first part of a story — lies in the statement of the case, of course: geographic fragmentation is an obstacle to labour mobility and to the development of infrastructure that would support national markets for freight services, energy transmission and distribution, water distribution, post and telecommunications, and so on.

But that is not the whole story by any means. It is worth considering whether competitive federalism is not a second part of the story. Competitive federalism may be contrasted with cooperative federalism. Looking back over the whole period since federation, one would have to conclude that cooperative federalism is much the weaker of the two — characterised by only irregular and infrequent bursts of activity.

Competitive federalism asserts that there is a national interest in fostering sub-national decision making in respect of things that are of national importance. The proposition is that while competition among sub-national governments will initially produce a number of different policy models, that same competition will eventually produce convergence on a model better than what any national government would likely be able to design and/or implement.

So, is competitive federalism the reason why nationally operated trains have to be equipped with eight different radios? Does competitive federalism explain why we have such a plethora of inconsistent state-based regulatory requirements for occupational licensing, occupational health and safety, road transport, water trading, and so on? Possibly. But there is a more likely explanation: a stubborn parochial interest in putting the welfare of the State or Territory ahead of that of the nation.

Parochialism is understandable. But a proper accounting of its national economic consequences would be weighted heavily in the negative.

A third part of the story — and this is the story's central chapter — is a community sensitivity to market-determined prices, and also quantities; that is, a sensitivity to market-determined patterns of resource allocation. This barrier to the development of efficient markets is at least as old as government. One, rather obvious, reason for

its potency is that governments find it easier to tell one group of people they can not have something they have never had, than to tell another group that they should pay more to keep what they already have.

In behavioural economics this phenomenon is referred to as an endowment effect. The political system understands endowment effects.

The political system also helps citizens to appreciate various 'facts of life'. For example, one often hears these days that, because of persistently bad weather patterns, urban Australians will just have to learn to live with permanent water restrictions. It might not be long before we hear that, again because of the weather, we will simply have to learn to live with persistent peak-period 'black-outs' and 'brown-outs'.

Another emerging fact of life is a doubling within the next 15 years of the number of trucks jostling for road space on our major highways.

In the early-1980s many Australians had to learn to live with the fact that they could not get a home loan from a bank. This was because of a consensus that it was unacceptable that those lucky ones at the front of the queue should have to pay an interest rate above a legislated maximum. Better that those who did not already have a bank home loan go elsewhere and pay a good deal more.

But then, in April 1986, the interest rate ceiling was removed. Overnight, a policy 'fact of life' had been consigned to history.

It is well past time some of our other policy 'facts of life' suffered the same fate. It is time to 'get real' on national productivity reform.

The two biggest threats to economic reform in Australia are an aversion to the logic of markets and stubborn parochialism. Neither of these threats is new.

Parochialism and an aversion to markets will never deliver an efficient national electricity market, national markets for labour, a national market for water, or efficient road and rail freight networks.

These enduring threats to economic reform pose substantial risks to the cost structure of Australian producers facing increasingly intense competition from the dynamic emerging economies of China and India. And unless tackled courageously, they will consign us to a permanent productivity gap with the top half of the OECD — and a reversal of the recent narrowing of the GDP per capita gap.

The expansive CoAG, and related, reform agenda provide an unusual opportunity for policy makers at all levels of government to embrace the logic of markets in

labour, energy, water and land transport; and to embrace the spirit of cooperative federalism. If they do, there is a very real chance that our peers in Washington and Paris will be talking about the golden age of Australian economic performance for decades to come.

A Roundtable program

Day 1 — Thursday 27 October 2005

8.45 — 9.00	Registration	
9.00 — 9.20	**Welcome and introduction**	
	Gary Banks (Productivity Commission)	

Session 1: Institutional frameworks to promote productive outcomes

	Chair:	Gary Banks
9.20 — 10.00	*Speakers*:	Jonathan Pincus (Productivity Commission) Cliff Walsh (SA Centre for Economic Studies)
10.00 — 10.15	Short break	
10.15 — 10.45	*Discussant*:	Ross Garnaut (Australian National University)
10.45 — 12.00	*General discussion*	
12.00 — 1.15	Lunch	

Session 2: Case study one — health reform

	Chair:	Robert Fitzgerald (Productivity Commission)
1.15 — 1.55	*Speakers*:	Vince FitzGerald (Allen Consulting Group) Andrew Podger (PM's Health Task Force)
1.55 — 2.10	*Discussant*:	Stephen Duckett (LaTrobe University)
2.10 — 3.00	*General discussion*	
3.00 — 3.15	Short break	

Session 3: Case study two — labour market reform

	Chair:	Judith Sloan (Productivity Commission)
3.15 — 3.55	*Speakers*:	Andrew Stewart (Flinders University)
		Peter Anderson (Australian Chamber of Commerce and Industry)
3.55 — 4.10	*Discussant*:	John Freebairn (Melbourne University)
4.10 — 5.00	*General discussion*	
7.00	Pre-dinner drinks	
7.30	Dinner (Speaker: Ken Henry, Australian Treasury)	

Day 2 — Friday 28 October 2005

Session 4: Case study three — freight transport reform

	Chair:	Philip Weickhardt (Productivity Commission)
9.00 — 9.40	*Speakers*:	Rod Sims (Port Jackson Partners Limited) Tony Wilson (National Transport Commission)
9.40 — 9.55	*Discussant*:	Henry Ergas (Charles River Associates)
9.55 — 10.45	*General discussion*	
10.45 — 11.00	Short break	

Session 5: Panel discussion — 'The way forward'

	Chair:	Gary Banks
11.00 — 11.40	*Panellists*:	Geoffrey Brennan (Australian National University) Paul Kelly (Editor, The Australian)
		John Langoulant (Chamber of Commerce and Industry of WA) John Roskam (Institute of Public Affairs)
11.40 — 12.30	*General discussion*	
12.30 — 12.40	*Closing remarks*	
12.40 — 1.40	Lunch	

B Roundtable participants

Mr Mark Altus	Department of Treasury and Finance, Western Australia
Mr Peter Anderson	Policy Director, Australian Chamber of Commerce and Industry
Mr Gary Banks	Chairman, Productivity Commission
Mr Ian Bickerdyke	Productivity Commission
Mr David Borthwick	Secretary, Dept of the Environment and Heritage
Mr Gerard Bradley	Under Treasurer, Qld Treasury
Prof Geoffrey Brennan	Research School of Social Sciences, Australian National University
Mr Geoff Carmody	Director, Access Economics
Prof Stephen Duckett	Dean of the Faculty of Health Sciences, LaTrobe University
Dr Henry Ergas	Charles River Associates
Mr Robert Fitzgerald	Productivity Commission
Dr Vince FitzGerald	Chairman, The Allen Consulting Group
Prof John Freebairn	Director, Melbourne Institute of Applied Economic and Social Research
Prof Ross Garnaut	School of Pacific and Asian Studies, Australian National University
Mr Paul Gretton	Productivity Commission
Dr Paul Grimes	Under Treasurer, ACT Treasury
Ms Lisa Gropp	Productivity Commission
Mr Jim Groves	Consultant, National Rural Health Alliance
Ms Jenny Goddard	Deputy Secretary, Department of the Prime Minister and Cabinet
Mr Don Henry	Executive Director, Australian Conservation Foundation
Dr Ken Henry	Secretary, Treasury

Mr Tony Hinton	Productivity Commission
Ms Sue Holmes	Productivity Commission
Mr Paul Kelly	Editor, The Australian
Mr Michael Kirby	Productivity Commission
Mr John Langoulant	Chief Executive, Chamber of Commerce and Industry of WA
Mr Ralph Lattimore	Productivity Commission
Mr Ian Little	Secretary, Dept of Treasury and Finance, Victoria
Mr Lawrence McDonald	Productivity Commission
Ms Rosalie McLachlan	Productivity Commission
Mr Alan Mitchell	Economics Editor, Australian Financial Review
Mr Ian Monday	Productivity Commission
Mr Barry Moore	Director Policy, National Transport Commission
Mr Des Moore	Director, Institute for Private Enterprise
Dr Greg Mundy	Chief Executive Officer, Aged and Community Services, Australia
Ms Mary Murnane	Deputy Secretary, Dept of Health and Ageing
Mr Rob Nicholl	Deputy Secretary, Dept of Treasury and Finance, Tasmania
Assoc Prof Jeff Petchey	Director, Federalism and Regional Economics Research Unit, Curtin University
Dr Jonathan Pincus	Productivity Commission
Mr Garth Pitkethly	Productivity Commission
Mr Andrew Podger	Prime Minister's Health Task Force
Mr John Roskam	Executive Director, Institute of Public Affairs
Mr Gary Samuels	Productivity Commission
Mr Chris Sayers	Productivity Commission
Mr Rod Sims	Director, Port Jackson Partners Limited
Prof Judith Sloan	Productivity Commission
Prof Andrew Stewart	School of Law, Flinders University

Mr Tony Stubbin	Assistant Under Treasurer, Economics, NT Treasury
Mr Michael Taylor	Secretary, Dept of Transport and Regional Services
Mr Paul Tilley	First Assistant Secretary, Economic Division, Dept of the Prime Minister and Cabinet
Mr David Tune	Executive Director, Fiscal Group, Treasury
Prof Cliff Walsh	Research Associate, SA Centre for Economic Studies, University of Adelaide
Mr Philip Weickhardt	Productivity Commission
Mr Roger Wilkins	Director-General, NSW Cabinet Office
Mr Tony Wilson	Chief Executive Officer, National Transport Commission
Mr Andrew Witheford	Senior Adviser, Australian Industry Group
Mr Bernie Wonder	Productivity Commission
Mr Alan Wood	Economics Editor, The Australian
Mr Jim Wright	Under Treasurer, SA Treasury

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