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## 8 Australia's federal context\*

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### 8.1 Australian federalism

Australian federalism has evolved since its beginnings over a century ago into a system where the Commonwealth government is engaged in a wide range of policy areas that were once the sole responsibility of the States. This system of 'cooperative federalism' has prompted efforts to establish new and more efficient and effective modes of intergovernmental coordination. At the centre of those efforts has been COAG, the Council of Australian Governments. At issue has been the operation of the extensive system of 'tied' grants through which the Commonwealth shapes policy in areas of State jurisdiction. While the States retain primary responsibility for most service delivery, they increasingly do so within the context of an overarching national framework.

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\* The views expressed in this chapter are those of the authors, and do not necessarily represent the views of the Steering Committee for the Review of Government Service Provision.

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## The constitutional division of powers

The division of powers in Australia's Constitution was deliberately decentralised. The Commonwealth was assigned limited and specific powers, whereas State powers are general (box 1). The intention and expectation at federation was that the States would retain exclusive responsibility for most domestic governance tasks and that little coordination would be required between the two levels of government (Fenna 2007b). In particular, most of the service delivery responsibilities of government in areas such as education, health and infrastructure as well as regulatory responsibilities in areas such as land use and the environment, were left exclusively to the States. The two levels were assigned concurrent jurisdiction in respect of all forms of taxation except customs and excise, which were prohibited to the States.

### Box 8.1 Australian and State government division of powers

The Australian Constitution assigns the Australian Government:

- a small number of exclusive powers — mainly in respect of customs and excise duties, the coining of money and holding of referenda for constitutional change ; and
- a large number of areas where it can exercise powers concurrently with the States. To the extent that State laws are inconsistent with those of the Commonwealth Government in these areas, the laws of the Commonwealth prevail (s.109).

State governments have responsibility for all other matters. However, even where the Constitution does not give the Commonwealth explicit power, it may be able to draw on more general powers, such as the 'corporations' power and the 'external affairs' power. Further, the Australian Government can influence State policies and programs by granting financial assistance on terms and conditions that it specifies (s.96).

Sources: PC 2006a, 2006b; Fenna 2007b.

## Centralisation

In practice, the distribution of powers has become significantly more centralised over time, even though the Constitution itself remains largely unchanged (Fenna 2007a, 2012). Since federation, there has been an expansion in the role of government in general, and of the Commonwealth's role in particular. For the most part, increasing centralisation of power in Australia has occurred through expansive interpretation of the Commonwealth's enumerated powers by the High Court (s.51). These decisions have reduced State taxing powers; allowed the Commonwealth to deploy its 'spending power' to direct the States; and given very broad scope to the

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Commonwealth's enumerated powers areas as that over 'external affairs' and the 'corporations power'.

## **8.2 Federal financial relations**

Pivotal to the relationship between the Commonwealth and the States in Australian federalism is the very different financial position of the two levels of government, the dependence of the States on grants from the Commonwealth, and the capacity that financial superiority gives the Commonwealth (Fenna 2008).

### **Vertical fiscal imbalance**

Because the customs tariff that was assigned exclusively to the Commonwealth was such an important source of revenue at the time, Australia federalism began with a significant degree of 'vertical fiscal imbalance' (VFI). The Commonwealth's revenues exceeded its minor spending needs, whereas the extensive service delivery responsibilities of the States exceeded their revenues. Since then the disparity has increased. Over time the High Court interpreted the tariff and excise prohibition as encompassing any kind of State sales tax; and in 1942, the Commonwealth took the personal and corporate income tax from the States. The Commonwealth now controls approximately 82 per cent of all tax revenue raised in Australia. In 2007-08 (the most recent year for which consistent data are available), around 46 per cent of total State revenue was provided by the Commonwealth.

An extensive system of intergovernmental transfers has developed to redress the imbalance. The Commonwealth traditionally allocated funds to the States either as general purpose grants or specific purpose payments (SPPs) — that is to say, either with no particular strings attached or as 'tied grants' carrying any of a range of particular conditions.

**Table 8.1 Estimated State revenue, by source, 2009–10**

	<i>\$ billion</i>	<i>% of total</i>
Own source revenue		
Tax	55	28
Other <sup>a</sup>	43	22
<i>Subtotal</i>	98	50
Commonwealth transfers		
GST revenue (untied)	45	23
National Agreement SPPS (loosely tied) <sup>b</sup>	24	15
National Partnership Payments <sup>c</sup>	28	13
<i>Subtotal</i>	98	50
<b>Total</b>	<b>196</b>	<b>100.0</b>

<sup>a</sup> Includes sales of goods and services, regulatory fees and fines. <sup>b</sup> Specific Purpose Payments related to National Agreements must be spent in a nominated area, but do not have prescriptive conditions. <sup>c</sup> National Partnership Payments can include prescriptive conditions on how money is spent. **GST** Goods and Services Tax.

Source: ABS (2011), Government Finance Statistics, Australia, Cat. no. 5512.0.

Intergovernmental grants from the central government are characteristic of virtually all federations, even where sub-national governments have access to a range of revenue sources. Having the collection of some revenue sources centralised and others decentralised can reduce the overall cost of raising tax revenue and avoid competitive erosion of efficient tax bases (Pincus 2008). However, the degree of vertical fiscal imbalance in Australia has gone well beyond what such logic would suggest and well beyond the practice in comparable federations (Fenna 2008; Warren 2006).

VFI has become an issue, with many commentators noting the weakening of desirable links between taxation and expenditure decisions; the increased scope for the Commonwealth to become involved in areas of State responsibility (by attaching conditions to the use of transferred funds); and the heightening of political tensions around the allocation of revenue amongst the States (Garnaut and FitzGerald 2002). That said, replacement of the previous Commonwealth/State arrangements for untied grants with the proceeds of the GST ‘growth tax’ in 2000, and recent reforms to federal financial relations (discussed below) have shifted much of the focus of debate from the fiscal imbalance itself, to the mechanism for allocating Commonwealth transfers.

### **General purpose grants**

Commonwealth grants to the States embody a significant degree of horizontal fiscal equalisation (HFE), a mechanism designed to ‘equalise’ the ability of State governments to deliver services. In 1933, following threats by Western Australia to

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secede over claims of unfair financial treatment, the Commonwealth Grants Commission was established to advise on these special grants to the ‘weaker’ States. After the Commonwealth took over income tax from the States during the Second World War, the Grants Commission advised on the allocation to all States of shares of income tax. In 2000, the GST (Goods and Services Tax) was introduced, with all its net proceeds hypothecated to the States and the Grants Commission has been tasked with advising on the distribution of that revenue.

The Grants Commission describes the logic of HFE as follows:

State governments should receive funding from the Commonwealth such that, if each made the same effort to raise revenue from its own sources and operated at the same level of efficiency, each would have the capacity to provide services at the same standards. (CGC 2004)

This system has come under criticism at various times (Garnaut and FitzGerald 2002), most recently with the imbalances created by the mining boom (Fenna 2011; GST Distribution Review 2011; Porter 2011).

### **Tied grants**

For some decades now, a large proportion of the transfers from the Commonwealth to the States has come in the form of individual grants directed toward specific purposes and often with various ‘input’ conditions attached. Prior to the reforms of 2008–09, the number of these Specific Purpose Payments (SPPs) had grown rapidly, reaching around 100. They had also become increasingly prescriptive, most notoriously to the point where one SPP implemented by the Howard government required States to ensure that every school was flying the Australian flag. Since at least the mid-1990s, various inquiries and commissioned reports had recommended that the Commonwealth relinquish its ‘micro-managing’ role by replacing the myriad SPPs with a small number of block grants while at the same time asking the States to be more openly accountable for what they managed to achieve with those funds.

## **8.3 Cooperation and collaboration in Australia’s federation**

As noted, a distinctive feature of Australia’s federation is that many functions are now shared, rather than being exclusive to one level of government. What was by design a ‘coordinate’ system with each level of government operating

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independently in its own sphere has become in practice a system of ‘concurrent’ jurisdiction.

Competition among the States has seen the introduction of a range of policy innovations in fiscal affairs and service provision that have spread across jurisdictions. However, in some areas, competition has been more destructive than constructive (for example, ‘bidding wars’ for investment and erosion of efficient tax bases) and in many areas has led to ongoing diversity that has detracted from good national policy outcomes (regulations inhibiting mobility or scale, inter-jurisdictional externalities, excessive transactions costs). As a consequence, various mechanisms have developed to promote more cooperative and coordinated action in areas where reform on a national scale was generally seen as being important and beneficial (Painter 1998).

### **The architecture of intergovernmental relations in Australia**

Even before federation, the leaders of the Australian colonies met regularly to discuss issues of mutual interest or concern. From 1990 to 1992, Australian governments met in a series of Special Premiers’ Conferences to discuss the then-Prime Minister’s plan for a ‘Closer Partnership with the States’. At the last Heads of Government meeting in 11 May 1992, first ministers agreed to give their meetings more formal status as the Council of Australian Governments (COAG).

COAG was designed to operate as the main intergovernmental forum to ‘initiate, develop and monitor the implementation of policy reforms that are of national significance and which require cooperative action by Australian governments’. The operations of COAG are complemented by a range of Ministerial Councils, restructured most recently as ‘Standing Councils’ or ‘Select Councils’ (COAG 2011), which facilitate consultation and cooperation in specific policy areas. Ministerial Councils are mandated to develop policy reforms for consideration by COAG, and oversee the implementation of agreed policy reforms.

### **Recent reform experience**

The first wave of economic reform in Australia occurred within areas of Commonwealth responsibility in the 1980s, and involved the floating of the currency and reduction of barriers to foreign goods and capital. This in turn exposed performance problems in other parts of the economy, including inefficiencies in infrastructure industries dominated by public monopolies, anti-competitive regulation of many product and service markets, and rigidities in the labour market (Banks 2005).

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From the late 1980s, some governments accordingly started to tackle these problems in a second wave of reform. However, an Independent Committee of Inquiry into Competition Policy in Australia (Hilmer *et al.* 1993) demonstrated that effective implementation of many of the reforms required a more coordinated approach, and in April 1995, COAG committed to the National Competition Policy (NCC 2010).

The National Competition Policy included a range of reforms to expose government business enterprises to competitive pressures; to provide third-party access to essential infrastructure services and guard against the possibility of overcharging by monopoly service providers; and a process for reviewing a wide range of legislation that restricted competition (PC 2005).

The National Competition Policy was a landmark achievement in nationally coordinated economic reform. COAG (2005) stated at the conclusion of its June 2005 meeting:

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 ....

Key success factors included the formal commitment by all governments to specified reforms, and provision for 'competition payments' by the Australian Government to the States and Territories where they achieved satisfactory reform progress. Although the payments were relatively small (particularly in the context of the economic and social benefits that the States gain from undertaking reform), many commentators regarded them as essential to the reform process (PC 2005, 2006).

A third wave of reform, the National Reform Agenda, was agreed to in broad terms by COAG in February 2006. It encompasses three streams:

- competition reform, continuing the successful reforms of the 1990s
- regulation reform, to reduce the red tape burden on business
- human capital reform to improve health, learning and work outcomes, and therefore raise labour force participation and productivity in the face of an ageing demographic structure.

Like the National Competition Policy, the National Reform Agenda was based on the premise that cooperation between different tiers of government would lead to better outcomes for Australians. The States argued strongly for payments similar to those associated with the National Competition Policy, on the basis that, as much of

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the fiscal benefit of the reforms would accrue to the Commonwealth, the Commonwealth should share these benefits with the reforming jurisdictions (Department of Treasury and Finance 2006).

Ultimately, the 2008 reforms to federal financial relations re-introduced a version of incentive payments through National Partnership Payments to support the delivery of specified outputs or projects, to facilitate reforms or to reward those jurisdictions that deliver on nationally significant reforms (Commonwealth of Australia and States and Territories 2009).

Modelling by the Productivity Commission of the National Reform Agenda indicates that the gains from this ‘third wave’ of reform could potentially be greater than from the first and second waves, depending on the nature of the specific reforms and their budgetary costs (PC 2006c). However, many of the reforms involve significant complexities and uncertainties. This has ‘upped the ante’ on having good analysis based on good evidence to help avoid making mistakes on a national scale which previously would have been confined to particular jurisdictions (Banks 2008; 2009). One mechanism for generating such evidence is the COAG-commissioned Report on Government Services (see Banks and McDonald, this volume).

## **Federal fiscal reform**

Central to any real reform of intergovernmental relations in Australia, though, was reform to SPPs. States generally resented SPPs as ‘mechanisms for the Commonwealth to pursue its own policy objectives in areas of State responsibility’ (Ward 2009) and criticism was widespread (for example, Warren 2006). Many were narrowly focussed, prescriptive and inflexible. They inhibited the innovation and efficiency that can come from decision making attuned to local circumstances. For example, SPPs that required matching State funding led to States investing significantly more resources than they considered appropriate on some activities.

In November 2008, COAG endorsed a new Intergovernmental Agreement on Federal Financial Relations as part of a sweeping reform of Australian federalism launched by the incoming Labor government (Fenna and Anderson 2012). This aimed to replace existing SPPs with a small number of much less prescriptive transfers (COAG 2009). The agreement ‘rolled up’ multiple SPPs into five broad SPPs covering schools, vocational education and training, disability services, healthcare and affordable housing (Treasury 2009; 2010). Each SPP was associated with a new National Agreement that contained objectives, outcomes, outputs and performance indicators for each sector, and clarified the respective roles and

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responsibilities of the Commonwealth and the States in the delivery of services. (A sixth National Agreement, the National Indigenous Reform Agreement, is not associated with an SPP.) Importantly, the National Agreements do not prescribe how States are to use the money in the related SPPs (beyond requiring the money to be spent in the relevant service sector). Rather, governments' performance under the National Agreements is monitored and assessed by the COAG Reform Council — an independent body that reports to COAG.

As part of these reforms, COAG also agreed to a 'new' form of payment — National Partnerships — to fund specific projects and to facilitate and reward States that deliver on agreed reforms. As at mid-2010, there were around 142 such National Partnerships, and they accounted for over 50 per cent of total SPP payments in 2009-10. This 'proliferation', and their sometimes opportunistic or interventionist nature, has led to suggestions that the undesirable features of the old system are re-emerging (for example, O'Meara and Faithful 2012).

The Intergovernmental Agreement on Federal Financial Relations established the COAG Reform Council as the key accountability body within the COAG architecture. An independent review body, the Council reports directly to COAG on reforms of national significance that require cooperative action by Australian governments (see O'Loughlin, this volume). It is this move to a new focus on outcomes performance that has introduced benchmarking to Australian federalism in a systematic way.

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