
1 Productive reform in a federal system

Increasingly, the Commission is finding through its inquiries and other work that the capacity to build a more productive and sustainable Australia is linked to how well our federal system of government operates. A variety of ideas about better ways of running the federation have been advanced as part of the policy debate in this area over the last year or so. By and large, the competitive dimension of federalism, which provides in-built incentives for governments to perform better across a variety of areas, is operating well. However, the importance of the cooperative dimension of our federation is set to assume greater significance because of the growing interjurisdictional content of the reform task facing Australia.

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 1.1).

Box 1.1 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
- 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);

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- 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 intergovernmental 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, OECD 1997 and Joumard and Kongsrud 2003). 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 1.2).

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; 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, National Commission of Audit 1996).

Box 1.2 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).

- 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; and 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 1.3).

Box 1.3 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. (*John Howard, Reflections on Australian Federalism, 11 April 2005, p. 5*)
- We must address the increasingly untenable co-existence 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. (*Kevin Andrews, Where do we want workplace relations to be in five years time?, 25 February 2005, pp. 17–18*)
- 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. (*Bob Carr, Productivity Growth and Micro-Economic Reform, 27 February 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, Budget Strategy and Outlook 2005-06, Budget Paper No. 1, 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 Group, Governments Working Together: A better future for all Australians, May 2004, 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, Media Release, 1 June 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. (*The Speed Limit 2005-2025, Access Economics for the Business Council of Australia, May 2005, p. 26*)

In response to this debate and in recognition of the importance of the associated issues, the Productivity Commission's Annual Conference for 2005 is devoted to examining the challenges of securing *Productive Reform in a Federal System*. 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.

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 1.4).

Box 1.4 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 2004a). 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, SCNPMGTE 1994; PC 2005c).

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 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 2005a). 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 2005a). 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.

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 inter-governmental 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 2005a).

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 1.5.

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.

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.

Box 1.5 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 (1999, 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 1.6). The associated policy framework drew heavily on a blueprint established by an earlier independent inquiry, generally referred to as the Hilmer Inquiry (Hilmer et al. 1993).

NCP has been a landmark achievement in nationally coordinated economic reform (PC 2005a). 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 (1996), for example, took this view in several areas and made recommendations for realignments of responsibilities between the national and State governments.

Box 1.6 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 (2005a, 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.

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 2005a). 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 resource 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

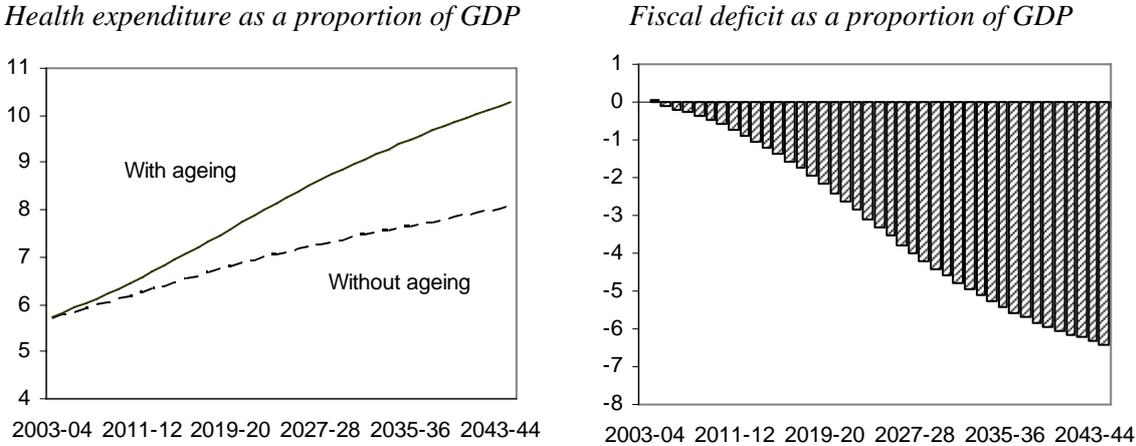
income growth by as much as a half by the mid-2020s compared to its 2003-04 growth rate (PC 2005b).

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 1.1).

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 1.1 Projected impacts of ageing on health expenditure and fiscal pressure
Share of GDP, per cent



Data source: PC (2005b).

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 2005a).

The Commission's research (PC 2005a,b), as well as other recent studies (Access Economics 2005a; 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 2005a) 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 1.7.

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 1.7 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 (2005a).

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 1.7, 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 2005a).

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 2005a).

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.

