



Australian Government
Department of the Prime Minister and Cabinet



Reform of the Federation

WHITE PAPER



A Federation for Our Future

ISSUES PAPER 1
September 2014

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ISBN 978-1-922098-77-1 (PDF)

ISBN 978-1-922098-78-8 (RTF)

ISBN 978-1-922098-79-5 (HTML)

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CONTENTS

Getting involved and having your say	iii
White Paper on the Reform of the Federation – Terms of Reference	iv
Overview: why reform the Federation?	1
Our evolving Federation – major changes since 1901	7
Issues for consideration	15
1. Values and goals that should underpin the Federation so it becomes more efficient and drives national productivity	16
2. Principles and criteria to be applied when allocating roles and responsibilities between different levels of government	18
3. Practical application of principles in the allocation of roles and responsibilities	26
4. The revenue / expenditure mismatch: vertical fiscal imbalance	30
5. Interstate equity: horizontal fiscal equalisation	33
6. Effectiveness and governance of federal financial relations	37
7. Improvements to the Council of Australian Governments	38
8. Performance reporting, transparency and data arrangements	39
Appendix A – Federalism – what is it and why is it important?	41
Appendix B – Economic and fiscal context	46
Appendix C – Examples of cooperative schemes	54
Glossary	56
References	57

GETTING INVOLVED AND HAVING YOUR SAY

The Commonwealth Government would like as many people as possible to be thinking about how our federal system of government can be improved.

A Green Paper setting out options for reform will be published in the first half of 2015, ahead of the publication of the White Paper towards the end of 2015.

Prior to the release of the Green Paper, a series of five issues papers will be published in the second half of 2014 to pose questions and promote public discussion. This issues paper is the first. Three papers will look at roles and responsibilities in the areas of health, education, and housing and homelessness. The final issues paper will consider issues with federal financial relations.

Comments on the issues papers can be made through the www.federation.dpmc.gov.au website.

The Green Paper will draw significantly on the feedback received in putting forward concrete options for reform. It will invite written submissions on these proposals.

Further details of the next steps of the public engagement process will be released soon on the website www.federation.dpmc.gov.au.

For more information please email federation@dpmc.gov.au.

WHITE PAPER ON THE REFORM OF THE FEDERATION – TERMS OF REFERENCE

Context

The Australian Constitution established Australia’s system of government as a federation comprising the Commonwealth Government and State governments.¹ One hundred and fourteen years later, Australia is a very different nation facing new challenges.

We remain a small population dispersed over a large land mass, but changes in technology and transport have connected us more to one another and to the world.

As a result, we are increasingly integrated into the global economy and society, and in particular the economic expansion and social transformations underway in Asia.

Our industries are undergoing significant and necessary restructuring, and the make-up of our population is changing: we have a greater proportion of people in older age groups, and a greater mix of people from across the globe choosing to make their home and their contribution here.

These new challenges mean that we need to make sure our federal structure is working. Our Federation is not, as some argue, a relic from the past, broken beyond repair and ill-suited to the times. Rather than seeking ever greater centralisation of power in the national government as a way of dealing with increasing complexity, now is the time to strengthen the way our federal system works by being clear about who is responsible for what.

According to the Australian Constitutional Values Survey 2012, the Australian public is generally supportive of a federal structure of government, but does not believe our Federation is functioning as well as it could be. Around two-thirds of Australians do not believe governments work well together, and believe the Federation needs reform.

A major part of the problem is that over time, the Commonwealth has become, for various reasons, increasingly involved in matters which have traditionally been the responsibility of the States and Territories. The States and Territories have become increasingly reliant on revenue collected by the Commonwealth to deliver services in the areas they are responsible for, with around 45 per cent of State and Territory revenue now coming from the Commonwealth.

¹ The Northern Territory and the Australian Capital Territory were conferred with self-government in 1978 and 1988 respectively.

Objectives

The Commonwealth Government has committed to produce, working with the States and Territories, a White Paper on the Reform of the Federation. The White Paper will seek to clarify roles and responsibilities to ensure that, as far as possible, the States and Territories are sovereign in their own sphere. The objective will be to:

- reduce and end, as far as possible, the waste, duplication and second guessing between different levels of government;
- achieve a more efficient and effective federation, and in so doing, improve national productivity;
- make interacting with government simpler for citizens;
- ensure our federal system:
 - a. is better understood and valued by Australians (and the case for reform supported);
 - b. has clearer allocation of roles and responsibilities;
 - c. enhances governments' autonomy, flexibility and political accountability; and
 - d. supports Australia's economic growth and international competitiveness.

Issues to be considered

Within the existing constitutional framework, consideration will be given to:

- the practicalities of limiting Commonwealth policies and funding to core national interest matters, as typified by the matters in section 51 of the Constitution;
- reducing or, if appropriate, eliminating overlap between Local, State and Commonwealth responsibility or involvement in the delivery and funding of public programmes;
- achieving agreement between State and Commonwealth governments about their distinct and mutually exclusive responsibilities and subsequent funding sources for associated programmes; and
- achieving equity and sustainability in the funding of any programmes that are deemed to be the responsibility of more than one level of government.

Consistent with this, the White Paper will present the Commonwealth Government's position in relation to:

- the values and goals that should underpin the Federation so it becomes more efficient and drives national productivity;
- principles and criteria to be applied when allocating roles and responsibilities between different levels of government, such as:
 - a. subsidiarity, whereby responsibility lies with the lowest level of government possible, allowing flexible approaches to improving outcomes,

- b. equity, efficiency and effectiveness of service delivery, including a specific focus on service delivery in the regions,
 - c. 'national interest' considerations, so that where it is appropriate, a national approach is adopted in preference to diversity across jurisdictions,
 - d. accountability for performance in delivering outcomes, but without imposing unnecessary reporting burdens and overly prescriptive controls,
 - e. durability (that is, the allocation of roles and responsibilities should be appropriate for the long-term), and
 - f. fiscal sustainability at both Commonwealth and State levels;
- practical application of these principles in the allocation of roles and responsibilities in the areas of health, education, housing and homelessness (Issues Papers will be produced on these areas) and other areas within scope, to a lesser degree, including transport infrastructure, Indigenous affairs, justice, disability, welfare services, settlement services, family and parental support, disaster recovery, environmental regulation, adult and community education and youth transitions;
 - how to address the issue of State governments raising insufficient revenues from their own sources to finance their spending responsibilities;
 - the most appropriate approach for ensuring that horizontal fiscal equalisation does not result in individual jurisdictions being disadvantaged in terms of the quality of services they can deliver to their citizens, noting that this principle needs to be implemented in a way that avoids creating disincentives for them to improve their own revenue generation or to make the reforms necessary to improve the operation of their economies;
 - effectiveness and governance of the current Intergovernmental Agreement on Federal Financial Relations, including the appropriateness of associated requirements in respect of inputs, outputs and outcomes;
 - improvements to the Council of Australian Governments' (COAG) operations so it is a strategic, consultative and co-operative decision-making forum, including for facilitating mutual recognition (as opposed to harmonisation) of State and Territory regulation; and
 - performance reporting, transparency and data arrangements.

The Federation White Paper will be closely aligned with the White Paper on the Reform of Australia's Tax System. The White Paper will also draw on any relevant findings and recommendations of the Commission of Audit and other White Papers and review processes currently underway.

Governance and Consultation

The Department of the Prime Minister and Cabinet has established a Taskforce to develop the White Paper. The White Paper will be a standing item on the COAG agenda and a Steering Committee, chaired by the Commonwealth and involving all States and Territories and the Australian Local Government Association, will oversee the development of the White Paper.

The White Paper will be developed with extensive consultation with business, non-government experts and the community. The Prime Minister's Business Advisory Council will play a key part in providing advice to assist the development of the White Paper.

Timing

Issues papers will be released in the second half of 2014. The Green Paper will be released in the first half of 2015 and the White Paper by the end of 2015.

OVERVIEW: WHY REFORM THE FEDERATION?

From 1 January 1901, the six colonies of Australia “agreed to unite in one indissoluble Federal Commonwealth”² This decision came after an extensive period of public debate and discussion about how the new nation of Australia should constitute itself, which included a series of Constitutional Conventions made up of delegates elected by ordinary voters, and culminating in referenda supporting the creation of the new nation.

Unlike the United States of America, whose constitution was born out of conflict and revolution, and which consequently has an iconic status in the minds of most Americans, the *Australian Constitution* and federal system were the fruit of discussion, agreement and peaceful evolution.³ Perhaps because of this we tend to take our federal system for granted, as something in the background of our national life, and not as something that requires periodic re-assessment as to how it is affecting our economic and social wellbeing. As John Brumby, Chair of the Council of Australian Governments (COAG) Reform Council, said earlier this year:

Australia is rated as at the top when it comes to governance and civic engagement, and close to the top when it comes to environmental quality and health status. We rate in the top 20 per cent when it comes to housing, personal security, jobs and earnings. These fantastic results didn't all just happen by chance or accident. Among other things, it is a result of our system of government – a federation – that is uniquely well-suited to responding quickly and creatively to global events and trends, while also meeting the diverse and changing needs of our local communities.⁴

Federal systems provide many financial and other benefits for their citizens. Some have argued that they tend to be overall more efficient than unitary systems of government.⁵ Federations constitute around 40 per cent of the world's population and around 50 per cent of world Gross Domestic Product (GDP).⁶ Federal systems also have the potential to improve productivity and efficiency through the innovation that comes from healthy policy competition between governments (see Appendix A for a fuller general discussion of federalism).

Given this, and our overall comparative performance in terms of national wellbeing, many Australians might ask why our federal system needs reform. However, according to the *Australian Constitutional Values Survey 2012*, around two-thirds of Australians do not believe governments work well together, and believe the Federation needs reform.⁷

The overarching goal of any reform process should be to improve the wellbeing and standard of living of Australians. However, the current operation of the Federation is not delivering the

² *Commonwealth of Australia Constitution Act 1900* (preamble), an Act of the Parliament of the United Kingdom.

³ G Craven, *Conversations with the Constitution: not just a piece of paper*, UNSW Press, Sydney, 2004.

⁴ J Brumby, *An Australian Federation for the Future – 2014 Hamer Lecture*, University of Melbourne, Melbourne, 2014.

⁵ According to the OECD (*Economic Outlook, Volume 2006/1, Number 79*, June 2006, Annex Table 25), in 2006 public spending as a share of Gross Domestic Product was 13 per cent higher on average in countries that have a unitary structure compared to federations. Based on these figures, if Australia were a unitary state, our 2006 public spending may have been \$44 billion greater in 2006 terms (A Twomey and G Withers, *Federalist Paper 1: Australia's Federal Future*, Council for the Australian Federation, 2007, p. 13).

⁶ Productivity Commission, *Productive Reform in a Federal System*, Roundtable Proceedings, 2006, p. 25.

⁷ A J Brown, *Australian Constitutional Values Survey*, Griffith University, 2012.

quality of public services it could be, is soaking up too much public funding that could be better spent on more pressing needs, and is holding back our national productivity.

The reason for this is the way intergovernmental relations have evolved over time in response to social and political changes, and the interaction between various sections of the Constitution. These factors have led to a high degree of unproductive overlap and duplication between levels of government.

For example, section 51 of the Australian Constitution enables the Commonwealth Parliament to make laws in respect of various areas of society and economic activity. This fundamental section of our Constitution has had a profound impact on our lives, whether we realise it or not. Section 51 does not prevent the States from also making laws in these areas, but section 109 makes it clear that the Commonwealth's laws will always prevail over State laws in these areas to the extent that there is any inconsistency between them. Section 96 allows the Commonwealth Parliament to "grant financial assistance to any State on such terms and conditions as the Parliament thinks fit."

Over the last century, the role of the Commonwealth has gradually expanded into more areas of government activity that many regard as the traditional sphere of the States and Territories, particularly through the use of tied grants under section 96 of the Constitution. This Commonwealth expansion has led not only to inefficient overlap and duplication – with associated cost- and blame-shifting – but loss of accountability to voters, and has also impinged on States' sovereignty. This has partly been possible because the States and Territories are reliant on revenue collected by the Commonwealth to deliver services in the areas they are responsible for, with around 45 per cent of State and Territory revenue now coming from the Commonwealth.⁸

There are other very good reasons for looking with fresh eyes at how our federal system operates. Having multiple governments invariably leads to multiple legal and regulatory systems.⁹ This can make it harder for businesses to operate in more than one jurisdiction, can hinder businesses' competitiveness in export markets, and can frustrate the efficient operation of national markets. There is significant scope for improving the efficiency and effectiveness of our Federation by finding ways to reduce as far as possible the duplication and overlap between different levels of government.¹⁰

Overlap and duplication in spending and policy responsibilities can add costs to government, and therefore make taxes higher than they need to be. This cost is compounded if there are inefficiencies on the revenue side as well. While it is difficult to accurately estimate such costs, Access Economics, in a report for the Business Council of Australia, estimated that:

⁸ The 45 per cent figure is an aggregate figure across all States and Territories. In some jurisdictions it is much higher, and in others much lower, than this figure. This issue is discussed further in Sections 4 and 5.

⁹ Business Council of Australia, *Reshaping Australia's Federation: A New Contract for Federal-State Relations*, Melbourne, 2006, p. 6.

¹⁰ It is important to note that some degree of overlap and duplication is inherent in all federations, and arguably may, under certain limited circumstances, be beneficial, if it leads to productive 'vertical competition' between levels of government. This aspect of federalism is discussed briefly in Section 3 of this paper.

the *fiscal* costs in Australia's current federalism system – the higher than necessary costs of government compared with an efficient ('ideal') federation could be almost \$9 billion in 2004-05... This represents an estimate of spending from which ordinary Australians are getting zero benefit, and hence having to pay the tax to finance that spending – all for nothing.¹¹

Reform has the potential to address these problems. Further, the difficult fiscal circumstances facing all levels of government make it timely to explore every avenue for making our system of government more efficient and effective in establishing the conditions under which all citizens can flourish and prosper.

This focus on reform of the Federation therefore needs to be considered as part of a broader public debate about what governments can realistically do to improve the freedom, opportunities and choices all citizens have available to them, in a sustainable way.

Clarifying roles and responsibilities: 'déjà vu all over again'?

The idea of looking afresh at the allocation of roles and responsibilities between the Commonwealth and the States and Territories is hardly new. Almost as soon as the ink was dry on the original Australian Constitution, debates began about the federal division of labour. For example, in 1911 and 1913, Prime Minister Fisher sought to expand the Commonwealth's powers through a referendum to change the Constitution. The Australian people, having only recently gone through an exhaustive process to determine who should do what, did not agree.

In understanding how we may reform the Federation for the next century, it is important to understand the evolution of Commonwealth-State relations since 1901. There has been a shift in power towards the Commonwealth since Federation. This has been due to a mixture of High Court decisions, referenda results and the policy objectives of governments – all of which are best understood in their broader context.

High Court decisions have influenced (and in some cases determined) the revenue-raising capacities of the Commonwealth and States, and the interpretation of their powers. The importance of these decisions should not be underestimated; from the landmark *Engineers Case* in 1920 to *Williams No.2* in 2014, the role of the High Court has been crucial in informing the federal balance.

The reluctance of Australians to change their Constitution is well-known; only eight out of forty-four referenda have been successful. Two of the most successful expanded the Commonwealth's scope of legislative power. In 1946, in an era of post-war reconstruction, a majority of voters in every State supported the expansion of Commonwealth legislative powers in social services. This was followed in 1967, when a proposal to give the Commonwealth Parliament power to make laws with respect to Indigenous Australians was supported by more than 90 per cent of Australians.

While some governments have tried (and sometimes succeeded) to further their policy objectives through the legal system or referenda, others have taken a different path. The use of section 96 to transfer funding from the Commonwealth to the States (through tied grants) was

¹¹ Business Council of Australia, Appendix 2: The Costs of Federalism. This does not include the additional costs to business of having to negotiate overlapping regulation.

first sanctioned by the High Court in 1926 but became commonplace from the 1970s onwards. The economy, globalisation, national security and technological advances have led some governments to adopt various forms of cooperative mechanisms (for more detail see Appendix C) in order for the Federation to run efficiently and effectively. However, some of these agreements have become too focussed on input controls, thereby undermining their objective.

So a lot has changed in the last century, but the issue of how to ensure the Federation works as well as it can is a recurring theme of the last 114 years. Most recently, the National Commission of Audit stated:

the current operation of the Australian Federation poses particular challenges to the delivery of good, responsible government ... A thorough reassessment of roles and responsibilities across all levels of government is needed as a matter of urgency.¹²

In a recent overview of Budget Reviews and Commissions of Audit in Australia, the Parliamentary Library noted that “inefficiencies arising because of overlap and duplication between the Commonwealth and the States and Territories were first discussed at length by the 1980–81 Commonwealth review. That review recommended rationalising those functions which were considered to ‘properly belong to the Commonwealth’”.¹³ Prime Minister Fraser intended to implement the “Transfer of Functions to the States” in order to eliminate “overlap, waste and interference in the delivery of service and functions”.¹⁴ He lost the 1983 election before these reforms could be implemented.

Later, in the 1990s, the issue of the appropriate division of roles and responsibilities between the two levels of government was the subject of attention from the 1996 National Commission of Audit and the 1996 Queensland review, both of which concluded that rationalisation of roles and responsibilities of the two levels of government was urgent and a matter of high priority.

There has, in the view of some, been little real progress:

Politicians and bureaucrats across the political spectrum and at all three levels of government will happily agree that the federation is ‘broken’ and ‘dysfunctional’ on both the revenue and expenditure sides yet equally, over a quarter of a century or more, they have all indulged in an orgy of inaction in terms of improving the situation.¹⁵

This is not to say there has been no progress. There are examples where jurisdictions have worked together to rationalise and harmonise regulation, including in family law in the 1970s, and companies and securities regulation in the 1980s and 1990s. Then in 2008, the Intergovernmental Agreement on Federal Financial Relations sought to return more autonomy to States and Territories in how they spent funds provided to them by the Commonwealth. However, since then the COAG Reform Council noted that there has been a proliferation of National Partnerships, with States reporting that many include significant specification and

¹² Commonwealth of Australia, *Towards Responsible Government – The Report of the National Commission of Audit*, Canberra, 2014, pp. 68-69.

¹³ Parliamentary Library, *Budget Reviews and Commissions of Audit in Australia*, Research Paper Series 2013-14, Canberra, 2014.

¹⁴ Parliamentary Library, p. 13.

¹⁵ N Greiner, ‘Federal system lacks accountability’ *Australian Financial Review*, 5 May 2014.

monitoring of inputs and activities, thereby reimposing controls and constraints.¹⁶ There was a total of 145 agreements at 1 July 2013, compared to 81 at 1 July 2009.¹⁷

So why should talk of reforming the Federation be any different this time around?

First, the Commonwealth Government is committed to ensuring that our Federation results in States and Territories being sovereign in their own sphere. This means States and Territories having greater autonomy, but also accountability, in the areas of activity for which they are responsible.

Second, previous reviews which had called for change did not have a process in place to take their recommendations forward and develop more detailed proposals for implementation. The White Paper on the Reform of the Federation is such a vehicle. Importantly, the White Paper is being developed in a collaborative manner with the States and Territories. At the meeting of COAG on 2 May 2014, the Prime Minister stated that it is a “constructive and collegial operation”.¹⁸

Third, this time around revenue is on the table as well, including through the White Paper on the Reform of Australia’s Tax System. Bold ideas to reform responsibilities and consider the revenue and expenditure mismatch between the Commonwealth and the States and Territories can come to nothing unless governments are also able to have a sensible discussion about who raises the revenue (that is, who is responsible for policy decisions about particular taxes), and how revenue is best shared between levels of government to fund their respective responsibilities. Such a discussion opens up the possibility for realignment of spending and revenue-raising responsibilities, noting that any such proposals would need to be fully considered and properly managed.

Finally, there are strong financial and economic imperatives for action. Governments at both the Commonwealth and State and Territory levels simply cannot afford a continuation of the inefficiency generated by duplication and overlap in programmes and administration. Instead, they are looking to more effective governance and political accountability with the potential to drive real reform that can deliver an economic ‘federation dividend’ to the national economy and to public finances (see Appendix B for a discussion of the current economic and fiscal context).

The need for partnership between governments

To be successful, the White Paper needs to be developed with close cooperation between the Commonwealth and the States and Territories. Implementation of the proposals that emerge will require coordination across all levels of government. The challenges of large-scale reform should not be under-estimated, as Gary Sturges, one of the key figures in the development and implementation of the National Competition Policy, has written:

¹⁶ COAG Reform Council, *Lessons for federal reform: COAG reform agenda 2008-2013*, COAG Reform Council, Sydney, 2013, p. 44. As Alan Fenna observed in 2008, “tied grants may be pruned back, but there is little to stop them sprouting up afresh and little to arrest a return to the old ways”: A Fenna, ‘Commonwealth Fiscal Power and Australian Federalism’, *UNSW Law Journal*; vol. 31(2), 2008, p. 528.

¹⁷ Since 2013, governments have made progress in rationalising funding agreements and reducing their reporting burden.

¹⁸ COAG Press Conference 2 May 2014, <<https://www.pm.gov.au/media/2014-05-02/council-australian-governments-press-conference-parliament-house-canberra-0>>.

Many people, including many academic economists, think of government as a single organisation, managed by a chief executive or a board with a single set of policy objectives. If government were such an organisation, then the coordination of policy-making and implementation, of regulation and service delivery would be largely a matter of command and control. Overlap and duplication could be eliminated through fiat, and programs could be coordinated simply by relocating authority upwards to an official higher in the chain of command. In reality, the governance of large-scale societies is much more complicated than this.¹⁹

In this context, the prospect of achieving any meaningful reform of the Federation, with lasting and positive impacts for the nation, will only be realistic if the legitimate role of all levels of government is properly recognised in the process of developing options, and all governments are willing to consider the best interests of the nation.

Although the White Paper is a Commonwealth initiative, a joint Steering Committee to oversee the development of the White Paper has been established, comprising the Secretaries or Chief Executives of First Ministers' departments. This is in recognition of the need for a genuine partnership. Chaired by the Secretary of the Department of the Prime Minister and Cabinet, it will also have representation from the Australian Local Government Association. It will advise First Ministers on progress at various stages of the process.

This approach is consistent with the advice of the Organisation for Economic Cooperation and Development (OECD) in its May 2014 report, *All on board: making inclusive growth happen*:

Inclusive policy making and service delivery requires effective decentralisation of policies which allows better targeted place-based policies. Sub-national governments are often much better positioned to plan and manage investment and service-delivery 'at street level'. Yet, effective decentralisation for inclusive growth requires a solid whole-of-government coordination and a clear division of responsibilities for the actions taken at the different levels of government.²⁰

In other words, a collaborative and collegiate process is necessary to ensure the best outcomes from reform.

¹⁹ G Sturgess, *The Great Barrier Reef Partnership: Cooperation in the Management of a World Heritage Area*, Queensland Government, Brisbane, 1999, p. 25.

²⁰ Organisation for Economic Cooperation and Development, *All on board: making inclusive growth happen*, OECD, Paris, 2014, p. 16.

OUR EVOLVING FEDERATION – MAJOR CHANGES SINCE 1901

Key points

- Since Federation, there has been a shift in power towards the Commonwealth.
- This has been due to a mixture of High Court decisions, key referenda results and the policy objectives of governments, particularly the Commonwealth.
- With minor exceptions, the trend towards centralisation has accelerated since 1972.

One theme of the more than one hundred years since Federation has been the gradual encroachment by the Commonwealth on areas regarded by many as traditionally the responsibility of the States and Territories. The current division of roles and responsibilities between the Commonwealth and State and Territory governments bears limited resemblance to how it looked in 1901. This is due to several factors, including decisions of the High Court, various referenda results and policies pursued by different Commonwealth governments.

Pre-Federation

The drafters of the Australian Constitution were heavily influenced by the US Constitution. This included the manner in which roles and responsibilities were assigned to the Commonwealth.²¹ The Commonwealth Parliament was given a specific and limited list of legislative powers, most of which it was to hold concurrently with the States.²² Sections 106 and 107 of the Constitution preserved the constitutions and laws of the original Colonies, subject to amendments necessary to enable the establishment of national government.²³ This arrangement can arguably be said to have set the foundation for any future ‘federal balance’ between the Commonwealth and the States. The Constitution makes it clear that if a State law and Commonwealth law are inconsistent, the Commonwealth law overrides the State law to the extent of the inconsistency.²⁴

1901 - 1919

For the first two decades after Federation, the balance between the Commonwealth and the States did not vary significantly from what was agreed in 1901. The High Court might be seen to have routinely decided matters of Constitutional interpretation in favour of the States. One important exception occurred in 1908,²⁵ where the High Court’s interpretation of ‘surplus revenue’ effectively denied the States access to a stream of revenue originally thought protected by section 94 of the Constitution.

²¹ It should be noted though that the US Constitution was developed in an era of suspicion and mistrust; Australian colonies chose to join together – the environment in which each developed was diametrically opposed. (G Craven, *Conversations with the Constitution: not just a piece of paper*, UNSW Press, Sydney, 2004.)

²² S Joseph and M Castan, *Federal Constitutional Law: A Contemporary View*, Thomson Reuters, Pyrmont, 2010.

²³ S Ratnapala and J Crowe, *Australian Constitutional Law: Foundations and Theory*, 3rd ed, OUP, South Melbourne, 2012, p. 34.

²⁴ Australian Constitution, section 109.

²⁵ *New South Wales v Commonwealth (Surplus Revenue Case)* (1908) 7 CLR 179.

In frustration at the various High Court decisions which did not support an expansion of Commonwealth powers,²⁶ Prime Minister Fisher in 1911 and 1913 introduced unsuccessful referenda proposals to enlarge Commonwealth powers under the Constitution. While Western Australia was the only State to record a majority voting in favour of any of the proposals in 1911, the results in 1913 were much closer.²⁷ A majority in Western Australia, Queensland and New South Wales all voted to expand the Commonwealth's powers in areas such as trade and commerce, monopolies and intervening in railway industrial disputes.²⁸ In 1915 the Commonwealth started to levy income taxes as a means of raising sufficient funds for its war-related expenditure. This incursion into a field which had been exclusively conducted by the States was to have far-reaching consequences.²⁹

1920 - 1945

This period was a mix of cooperative and coercive federalism, exemplified in part by a number of determinative High Court decisions that led to an expansion of Commonwealth powers and revenue-raising capacity.

In the landmark case *Amalgamated Society of Engineers v Adelaide Steamship Co Ltd (Engineers case)*,³⁰ decided two years after the end of the First World War, the High Court decided that Commonwealth powers should be interpreted as broadly as their language allowed, ignoring any conventions that may have been supposed about presuming States' responsibilities or any notion of 'Constitutional balance'. This decision gave the Commonwealth far more power than was sought by the Federal Government in the 1911 and 1913 referenda. It led to the incongruity of "a strange mismatch between a people refusing to vote extra powers to the Commonwealth and acquiescing in the expansion of the Commonwealth powers at the hands of judges".³¹ In 1926 the High Court upheld the Commonwealth's ability under section 96 to make conditional funding grants to States.³² This form of funding became increasingly used by the Commonwealth over the century, and expanded significantly under the Whitlam Government.

At a Constitutional Conference in Melbourne in 1934, some States proposed that the Commonwealth 'could vacate the field of income tax'. However, when the Commonwealth made a serious offer to withdraw from income taxing arrangements, the States rejected it.³³ This was the first of a number of occasions when the Commonwealth sought to offer to the States the opportunity for a greater role in levying income tax. Some commentators have noted that States were sensitive to the likely political ramifications of such an arrangement.³⁴

²⁶ P Bastian, *Andrew Fisher: An Underestimated Man*, UNSW Press, Sydney, 2010.

²⁷ A referendum proposal can only be successful if it is supported by a majority of voters and a majority of States.

²⁸ E Humphrey, *Andrew Fisher: The Forgotten Man*, Sport and Editorial Services Australia, Teesdale, 2008, p. 61.

²⁹ Between 1915 and 1942, income taxes were levied at both the State and federal level.

³⁰ *Amalgamated Society of Engineers v Adelaide Steamship Co Ltd* (1920) 28 CLR 129.

³¹ J Hirst, *The Sentimental Nation*, OUP, Melbourne, 2000, p. 295.

³² *Victoria v Commonwealth (Federal Roads Case)* (1926) 38 CLR 399.

³³ R Garran, *Prosper the Commonwealth*, Angus and Robertson, Sydney, 1958, pp. 207-8.

³⁴ Garran pp. 207-8; P Ayres, *Malcolm Fraser*, Heinemann, Richmond, 1987, p. 323

Robert Garran, who observed the Constitutional Conference, captured his understanding of the States' response to the prospect of taking back responsibility for income tax:

*We thank you for the offer of the cow,
But we can't milk, and so we answer now –
We answer with a loud resounding chorus:
Please keep the cow, and do the milking for us.*³⁵

Disagreement over income tax arrangements reached crisis point in the Second World War. The Commonwealth needed to increase its capacity to raise revenue in order to finance its war effort. After attempts to negotiate a system of uniform taxation failed, the Commonwealth introduced legislation to achieve this goal.

The legislation comprised four inter-related Acts:

1. the *Income Tax Act 1942* which imposed the tax itself;
2. the *States Grants (Income Tax reimbursement) Act 1942 (Grants Act)* which provided the States with generous financial assistance if the Treasurer was satisfied that the State had not imposed income tax;
3. the *Income Tax (War-time Arrangements) Act 1942* which effectively requisitioned State officers and other resources, such as accommodation and office equipment, connected with income tax, on the basis of Australia's war effort; and
4. a priority provision inserted into the *Income Tax Assessment Act 1942*, which made it an offence to pay State income tax before Commonwealth income tax.³⁶

Victoria, South Australia, Queensland and Western Australia challenged the scheme, unsuccessfully.

One of the arguments put forward by the States was that the *Grants Act* was invalid. They argued that the Commonwealth had acted beyond its power by offering, through section 96 grants, financial incentives to States if they elected not to impose income tax. The High Court rejected this argument, Chief Justice Latham noting that "The Grants Act offers an inducement to the State Parliaments not to exercise a power the continued existence of which is recognized – the power to impose income tax. The States may or may not yield to this inducement, but there is no legal compulsion to yield".³⁷ Thus, while this reading of section 96 enabled the Commonwealth to increase its tax-raising capacity by means of offering financially attractive arrangements to the States, there was no finding that States could not continue to impose income taxes; rather it was the political decision by States to accept conditions on section 96 grants that resulted in their effective ceding of income tax raising capacity.

1946 - 1972

The three decades following the end of the Second World War saw a further expansion of Commonwealth involvement in the roles and responsibilities of the States and Territories.

³⁵ Garran, p. 208.

³⁶ C Saunders, 'Uniform Income Tax Cases' in HP Lee and G Winterton (eds), *Australian Constitutional Landmarks*, CUP, Cambridge, 2003, p. 66.

³⁷ *First Uniform Tax Case (1942)* 65 CLR 373, 417, Latham CJ.

In 1946, a referendum was put to the Australian people proposing to extend the powers of the Commonwealth Parliament over a range of social services. A majority of voters in every State supported the proposal, which resulted in the insertion into the Constitution of the ‘benefits’ power found in section 51 (xxiiiA).³⁸

A referendum in 1967 gave the Commonwealth Parliament power to make laws with respect to Indigenous Australians. This proposal received the highest majority of any referendum; over 90 per cent of Australians supported the potential for Commonwealth involvement in Indigenous affairs.

A combination of High Court decisions and failed negotiations between the Commonwealth and the States regarding income taxing arrangements also entrenched the revenue-raising capacity of the Commonwealth. For example, in 1952 the Premiers’ Conference appointed a working party comprised of Commonwealth and State treasury officials to examine a number of issues relating to multi-jurisdictional income taxing arrangements. In 1953 the States again rejected an offer by the Commonwealth to resume taxing personal income. This rejection was driven by the smaller States of Western Australia and Tasmania, who had less capacity to raise taxes than their more prosperous colleagues.

1972 – 1983

Under Prime Minister Whitlam, the Commonwealth Government became involved in a wider range of activities. It used the mechanism of tied funding grants through section 96 to pursue its policy objectives. The Commonwealth became more heavily involved in health, education, housing, transport, local government and social/community services.

This period also saw several significant decisions of the High Court which arguably allowed the Commonwealth to use the external affairs power in section 51 (xxix) of the Constitution to become involved in matters which had previously been regarded by many as the responsibility of the States. In 1983, the majority of the High Court in *Commonwealth v Tasmania (Tasmanian Dams Case)* confirmed that the external affairs power supported domestic implementation of any bona fide obligation under an international agreement.³⁹ The decisions in *Murphyores v Commonwealth*⁴⁰ and *Tasmanian Dams* tended to confirm a direction of the Whitlam Government in entering into international agreements in a wide range of areas, such as the environment, heritage and human rights.

Prime Minister Fraser oversaw a change in direction for the relationship between the Commonwealth and the States. In 1977 he followed the example of Prime Minister Menzies in 1952 by offering to return income taxing powers to the States. As was the case twenty five years earlier, this offer was not accepted. This was one of four elements to Prime Minister Fraser’s ‘New Federalism’, the others being reducing the number of specific purpose grants, ensuring

³⁸ Section 51(xxiiiA) was inserted by the *Constitution Alteration (Social Services) 1946*.

³⁹ *Commonwealth v Tasmania* (1983) 158 CLR 1, Mason J (127), Murphy J (170-1), Brennan J (218-9) and Deane J (258-9).

⁴⁰ *Murphyores Inc. Pty Ltd v Commonwealth* (1976) 136 CLR 1.

access to revenue funds for local government, and a preference for “reasonable negotiation in areas where the State and Federal administrations interfaced”.⁴¹

The ‘New Federalism’ policy also marked the beginning of full and comprehensive horizontal fiscal equalisation amongst the States and Territories. This process was overseen by the Commonwealth Grants Commission, which had the task of assessing the relative financial capacity of all States, so that all States would have the capacity to provide services at the same standard. In the spirit of ‘New Federalism’, in 1981 Prime Minister Fraser announced a *Review of Commonwealth Functions*, with a view to reducing the role of the Commonwealth Government.⁴²

1984 – 2007

This period saw a renewed focus on the relationship between the Commonwealth and the States, focusing at different times on their roles in economic and social priorities.

Prime Minister Hawke convened a Special Premiers’ Conference in October 1990 to discuss the relationship between the Commonwealth and the States. Issues on the table included the duplication of services across governments, discussions about the tax system and the extent of Commonwealth conditions on funding transfers to States. However, following the change in leadership to Prime Minister Keating, there was a change in focus to proposed Commonwealth-State reforms. Discussions about devolution and financial arrangements slowed; focus instead turned to institutional changes, with the major reform being the establishment of the Council of Australian Governments (COAG).⁴³ A major initiative of the 1990s was the National Competition Policy, which was started under Prime Minister Hawke. The stakes for the country were recognised as being so high that it was also supported by the next two Prime Ministers, Keating and Howard, and a succession of Premiers and Chief Ministers, as “Politicians needed to remain publicly in support ... [the] cost of not participating remained higher in public perception than the reward for any go-slow.”⁴⁴ The National Competition Policy encouraged competitive federalism, whereby jurisdictions competed with each other to attract labour and investment. An increase in transparency and public reporting of targets further encouraged ‘good behaviour’ by the States.⁴⁵

In 1997 the High Court held that State business franchise fees on tobacco, alcohol and petrol were in fact excises, and thus prohibited by operation of section 90 of the Constitution, which prohibits States from levying excise.⁴⁶ This decision meant a significant, sudden and unexpected loss of revenue for the States. The Commonwealth responded by introducing ‘safety net’

⁴¹ P Ayres, *Malcolm Fraser*, Heinemann, Richmond, 1987, p. 324.

⁴² Parliamentary Library, *Budget Reviews and Commissions of Audit in Australia*, Research Paper Series 2013-14, Parliamentary Library, Canberra, 2014.

⁴³ Unlike its predecessor, the Premiers’ Conference, COAG included Chief Ministers from the Territories as well as the President of the Australian Local Government Association. Premiers’ Conferences predate Federation. They were used as vehicles to discuss the drafting of the Constitution, particularly its more contentious sections. Some of the functions of early Premiers’ Conferences were assumed by other bodies, such as the Loans Council and the Commonwealth Grants Commission.

⁴⁴ P Harris, *Speech to the Forum on Competition Policy and Deregulation: Challenges and Choices*, Australian National University, 7 March 2014.

⁴⁵ Harris.

⁴⁶ *Ha v New South Wales* (1997) 189 CLR 465.

measures whereby it increased its own excise or sales taxes on the affected commodities and passed the proceeds onto the States. However, in response to the need for a longer term solution, Prime Minister Howard announced the establishment of a Taxation Task Force to give consideration to a broadly based indirect tax system to replace some or all of the existing indirect tax bases, with any new taxation system involving major reductions in personal income tax.

Prime Minister Howard's reforms for *A New Tax System* proposed the introduction of the Goods and Services Tax (GST), which would be completely passed on to the States, with substantial reductions made to personal income taxes. In exchange for GST revenue, the States agreed to abolish inefficient taxes, such as taxes on banking and financial transactions, although progress on this has been mixed. The reform to distribute the GST to the States was sealed with the signing of the Intergovernmental Agreement on the Reform of Commonwealth-State Financial Arrangements 1999. Introduced in 2000, the GST is arguably the single-most important reform of the financial arrangements between the Commonwealth and the States since Federation.

Victoria put forward the National Reform Initiative in August 2005, which culminated in the National Reform Agenda, agreed at COAG. The National Reform Agenda shifted COAG's focus beyond economic policies, including competition and regulatory reform, to also include investing in human capital, particularly through reforming health and education.

One of the most far-reaching High Court decisions in recent years, *New South Wales v Commonwealth (Work Choices case)*⁴⁷ in 2006 resulted in an expansive reading of the corporations power in the Constitution, and gave the Commonwealth scope to intervene in a much wider range of issues. It is said to have represented a significant shift in the distribution of power from the States to the Federal Parliament, and is regarded by many as an important legal landmark in the Australian federalism landscape.

2008 - 2013

In November 2008, COAG agreed the Intergovernmental Agreement on Federal Financial Relations (IGA FFR). The IGA FFR reformed federal financial relations between the Commonwealth and the States. It aimed to provide a robust foundation for collaboration on policy development and service delivery and facilitate economic and social reforms in areas of national importance.

Two factors influenced the development of the IGA FFR: dissatisfaction with existing federal financial arrangements and COAG's increasing attention to social policy issues.⁴⁸ There was widespread support for the shift towards governments focusing on social policy outcomes, rather than input controls. However, concern soon appeared that the principles of IGA FFR were not being honoured by either the Commonwealth or the States and Territories. Cooperative federalism was again shifting towards coercive federalism.

⁴⁷ *New South Wales v Commonwealth* (2006) 229 CLR 1.

⁴⁸ COAG Reform Council, p. 22.

In the area of direct Commonwealth payments (in contrast to payments to States), more recent High Court decisions might be seen by some to have gone some way to ameliorate State and Territory concern regarding Commonwealth power. In *Pape v Commissioner of Taxation*⁴⁹ the High Court unanimously rejected the assumption that section 81 of the Constitution gave the Commonwealth a general power to spend and held that an appropriation was merely the permission which the Parliament gave to the executive to withdraw money from the Treasury – it did not itself confer a power to spend. Put simply, the Court held that there is no ‘appropriations power’; rather, the power to spend had to be found in the executive power of the Commonwealth under section 61 of the Constitution or in some other head of power.

In *Williams v Commonwealth* (2012) (*Williams No. 1*)⁵⁰ the Commonwealth argued that its capacity to spend and enter into contracts was very broad, and not limited to the subject-matters of the express grants of legislative power in sections 51, 52 and 122 of the Constitution. Without deciding that question, a majority of the High Court identified a different constitutional consideration; it held that payments made under the National School Chaplaincy Programme had not been validly made because they lacked statutory authority, and that statutory authority was essential in the circumstances of programme payments. The various judgments are complex. However, very broadly, the Court decided that there are significant categories of Commonwealth spending that require legislative authority even if there is an appropriation supporting the expenditure and the expenditure relates to a matter within the scope of Commonwealth legislative power.

The High Court in *Williams No. 1* revisited (without deciding) the question whether the Commonwealth’s power to enter into funding agreements and make payments is limited to subject matters of Commonwealth legislative power, most of which are enumerated in section 51 of the Constitution.

In August 2013 Mr Williams commenced further proceedings in the High Court challenging the validity of the arrangements made immediately following the High Court’s decision in *Williams No. 1*. The High Court delivered judgment in *Williams v Commonwealth* (*Williams No. 2*)⁵¹ on 19 June 2014. It confirmed the essential legislative limitation identified in *Williams No. 1*.

⁴⁹ *Pape v Commissioner of Taxation* (2009) 238 CLR 1.

⁵⁰ *Williams v Commonwealth* (2012) 248 CLR 156.

⁵¹ *Williams v Commonwealth* [2014] HCA 23.

CASE STUDY OF THE COMMONWEALTH'S INCREASING INVOLVEMENT IN AREAS OF STATE RESPONSIBILITY: SCHOOL EDUCATION

For the first six decades of Federation, State governments executed their constitutional responsibility for school education with minimal Commonwealth involvement. In the 1960s, an education 'crisis' elevated schools policy to the federal political sphere. Demographic and social changes following the Second World War fuelled enormous growth in school enrolments. Rising community expectations also placed upward pressure on the cost of school education. The non-government school sector also expanded during this period and by the early 1960s low-fee schools were struggling to remain viable.

The States' fiscal capacity to respond to increasing costs had been curtailed by the loss of revenue from income tax. They also faced competition from the non-government school sector for funding. Increasingly, the Commonwealth faced mounting public pressure to help finance both government and non-government schools. The fiscal imbalance between the Commonwealth and the States gave the Commonwealth the means to act and it now has a significant role in funding schools and shaping schools policy.

A number of the Commonwealth's constitutional powers enable it to intervene in schooling. For example, a 1946 referendum empowered the Commonwealth to make laws with respect to social services, including benefits to students (section 51 (xxiiiA)). However, the main power utilised by the Commonwealth has been section 96, which has allowed it to provide grant funding to States and Territories for particular purposes. Through this mechanism, the Commonwealth has also attached conditions on States and Territories and has influenced schools policy.

In 1964, the Commonwealth's first substantive venture into schools funding occurred when the Menzies Government responded to community concern about Australia's scientific capability by providing funding for school laboratories. Commonwealth capital assistance to schools was subsequently expanded and recurrent (per student) grants for non-government schools started in 1970. In response to ongoing financial concerns and policy objectives, the Commonwealth increased funding levels and extended recurrent grants to government schools. It also introduced several targeted education programmes and established the Australian Schools Commission to administer Commonwealth funding. While the Australian Schools Commission was abolished in 1988, the broad funding structure remained largely intact until 2009.

From the 1980s through to the first decade of the 21st century, the Commonwealth became more focused on school performance as concerns grew about the role of education policy in national economic and productivity reforms. Attention turned to school outcomes, literacy and numeracy skills and the values students learnt to equip them for work and further study.

Commonwealth involvement in schools policy intensified from 2008. Education Ministers from all Australian governments agreed to the development of a national curriculum and the implementation of several National Partnerships to strengthen policy settings with regard to students from low socio-economic status backgrounds, teacher quality, literacy and numeracy and school autonomy. The Australian Curriculum, Assessment and Reporting Authority was established to develop a national curriculum and implement the National Assessment Programme – Literacy and Numeracy (NAPLAN). Through the NAPLAN, the public reporting of results provides a mechanism to benchmark comparisons between States, and is an incentive for States to find ways to improve their performance.

ISSUES FOR CONSIDERATION

This issues paper sets out at a high-level the key issues that the White Paper will consider. These matters will be canvassed in more detail in forthcoming issues papers and in the Green Paper.

The Terms of Reference set out four overarching questions for investigation through the process:

Overarching Questions for Investigation

1. What are the practicalities of limiting Commonwealth policies and funding to core national interest matters, as typified by the matters in section 51 of the Constitution?
2. How can overlap between Local, State and Commonwealth responsibility or involvement in the delivery and funding of public programmes be reduced or, if appropriate, eliminated?
3. How can we achieve agreement between State and Commonwealth governments about their distinct and mutually exclusive responsibilities and subsequent funding sources for associated programmes?
4. How can we achieve equity and sustainability in the funding of any programmes that are deemed to be the responsibility of more than one level of government?

There is a disposition at all levels of government for reform that does not just take as given, or as inevitable, the current state of federal affairs. The complexity of modern societies and the global economy can justify a greater role for national governments, but the degree to which the Commonwealth has become involved in State and Territory affairs has arguably reached the point where there are diminishing returns, even negative returns, on that involvement. To what extent can we have 'clean lines', clear divisions of responsibility, whereby one level of government takes full responsibility for a number of areas of government activity, while the other level of government takes responsibility for others?

If this investigation shows that such a rebalancing can only take place to a limited degree, the next question is, how can we ensure that, where responsibility remains shared, that the duplication, overlap, waste and inefficiency are minimised by a more rational allocation of roles and clearer accountability within that area of shared responsibility? In these areas of shared responsibility, how can governments work together better to improve outcomes for citizens? Or are there circumstances where outcomes for citizens could be improved by different levels of government effectively competing in the same area of responsibility?

In seeking to answer these overarching questions, the White Paper process will need to develop positions on a number of matters. These are also set out in the Terms of Reference.

1. Values and goals that should underpin the Federation so it becomes more efficient and drives national productivity

It is a feature common to many people that we tend to assess the actions of those who lived in previous eras, or who live in another part of the world, as if they had a similar range of concerns, similar motives, and a similar framework for ethical judgement as we bring to the issues of our own time and place. Thus there are many people who would assess the movement towards Federation as being driven primarily by a desire to maximise economic efficiency, productivity and the benefits of free trade across State borders.

But such an assessment paints a limited picture of what was in fact a much richer public conversation in the lead up to Federation. Certainly the economic efficiency and productivity benefits played a large part in that debate, as did the benefits to local workers of tightening immigration laws. However, there was also a strong sense of people becoming part of a bigger, national community, something more significant that far transcended questions of economic efficiency and productivity.

Efficiency and productivity are often talked about as if they are the *ends* of public policy, whereas in fact their importance lies in the fact that they are *means*. Essentially, they are about making best use of the resources at our disposal, in the service of improving wellbeing and standards of living. But these are themselves often narrowly equated with economic growth. Certainly, economic growth is vitally important, but it too, ultimately, is also only a means to an end. What are the values and goals that as Australians we should be aspiring to achieve, and which serve as the motivation for making the most efficient and productive use of our resources?

Ultimately, governments should be aiming to establish the conditions under which, to the greatest degree possible, citizens have the freedom and opportunity to live the lives they have reason to value,⁵² to flourish and prosper. This is what is sometimes referred to as ‘the common good’. In Australia, we express this goal as a core value of the Australian national character in the phrase ‘a fair go’. This expresses a commitment to everyone having an equal opportunity to develop their capabilities and talents to allow them to thrive and to participate in the social and economic life of the nation, to become the best they can be through the responsible and reasonable use of their freedom.

In Australia, we should be particularly mindful of the difference in life chances that exist as a result of socio-economic disadvantage, especially in respect of Aboriginal and Torres Strait Islander peoples, and make it a priority to achieve governments’ commitment to Close the Gap in Indigenous life expectancy, child mortality, education and employment.

‘A fair go’ recognises that not all people start life with an equal endowment of material wealth or family and communal supports and other factors that can affect one’s chances of thriving. So, without seeking to equalise life outcomes for all Australians or providing a level of assistance that may act as a disincentive to effort and enterprise, a society that values ‘a fair go’ will, nevertheless, recognise that it has a responsibility to ensure that no member is without access to basic services and supports, and that, as far as practical, minimising inequality of opportunity is

⁵² Commonwealth Treasury, *Treasury’s Wellbeing Framework*, Canberra, 2012.

not only good from an ethical perspective but is good economics as well. The Organisation for Economic Cooperation and Development (OECD) has stated that:

Inequality of opportunity is detrimental to growth and well-being and requires paying attention to distributional effects of policies on different social groups. As long as all citizens have equal access to high-quality education, other public goods and services, finance and entrepreneurship, some level of inequality of outcomes is both economically inevitable and politically acceptable. However, inequality of opportunity can be particularly damaging when it locks in privilege and exclusion, which undermines intergenerational social mobility ... Policies that aim to address inequality of outcomes will fail unless they ensure more equal access to opportunity in the form of high quality education, health care and infrastructure, which remains unevenly spread both socially and geographically.⁵³

In a similar vein, in February 2014, the International Monetary Fund (IMF) released a discussion paper that considered the evidence about the relationship between redistribution, inequality and economic growth. The IMF referred to the:

tentative consensus in the literature that inequality can undermine progress in health and education, cause investment-reducing political and economic instability, and undercut the social consensus required to adjust in the face of shocks, and thus it tends to reduce the pace and durability of growth.⁵⁴

It concluded that “inequality may impede growth at least in part because it calls forth efforts to redistribute that themselves undercut growth. In such a situation, even if inequality is bad for growth, taxes and transfers may be precisely the wrong remedy”. In other words, policies that attempt to *compensate for* market inequalities through redistribution after tax were more likely to be a drag on economic growth than policies that attempt to *reduce* market inequalities in the first place and therefore require less redistributive effort. This is consistent with the Commonwealth Government’s belief that the best form of welfare is a job in the real economy, which also offers the opportunity of being able to make a contribution to national wellbeing through productive work.

Consistent with the principle of subsidiarity, when implementing measures to enhance opportunities for social and economic contribution, governments should aim to support rather than supplant the roles traditionally and more appropriately performed by families, businesses, and civil society organisations.

Other goals that could underpin the Federation include democratic principles such as participation, accountability and responsiveness, the need for citizen-centric service delivery, and the need for policy innovation and competition. Another goal is that of cooperation and mutual respect among governments to ensure national interest objectives are met.

⁵³ Organisation for Economic Cooperation and Development, p. 10.

⁵⁴ J Ostry, A Berg and C Tsangarides, *IMF Staff Discussion Note: Redistribution, Inequality and Growth*, International Monetary Fund, Washington DC, 2014.

Questions

- Efficiency, productivity, and economic growth are means, not ends. How should we express the ‘ends’, or the purpose of our federal governance structure?
- How can governments cooperate better and overcome the current barriers to doing so, such as political cycles and varying capabilities within Australian public services?

2. Principles and criteria to be applied when allocating roles and responsibilities between different levels of government

The White Paper will consider principles and criteria to be applied when allocating roles and responsibilities between different levels of government. They can be considered ‘design principles’ for designing, or re-designing, our Federation.

The White Paper’s Terms of Reference set out six principles:

- accountability for performance in delivering outcomes;
- subsidiarity;
- national interest considerations;
- equity, efficiency and effectiveness of service delivery;
- durability; and
- fiscal sustainability.

It is important to note that this list extends the list of four principles agreed at the Special Premiers’ Conferences in 1990 and 1991 as part of a previous attempt to reform our Federation. The four principles agreed at that time were nationhood, subsidiarity, structural efficiency and accountability. The focus on structural efficiency was borne out in the New Federalism agenda given expression in the National Competition Policy.

Each principle is considered further below. However, it is important to realise that these principles will often be in tension, and in choosing between different policy options, governments will necessarily need to consider the trade-offs between them.

Questions

- Are these the right principles? Are there additional principles that should be considered?
- How should these principles be prioritised?
- What are the likely trade-offs between the principles that need to be considered?

(a) Accountability for performance in delivering outcomes

The overarching principle for the White Paper is accountability. Our national governance is less than what it should be because it is not clear to voters who is responsible for what, and who they should hold accountable when problems arise or who they should reward when things improve.

This principle asserts that good public accountability mechanisms allow the public to hold the appropriate level of government to account for the quality and efficiency of the services delivered and outcomes achieved. A key part of this good public accountability is increased transparency about roles and responsibilities between different levels of government.

There are three types of accountability that are important in public governance:

1. political accountability of governments to their electorate for the effectiveness of the policies and programmes for which they are responsible;
2. regulatory and performance compliance for which Ministers are held accountable through reporting to Parliament; and
3. financial accountability for expenditure, which flows from the appropriation powers of Parliaments and compliance is then monitored through departments of finance and offices of Auditors-General.

The Intergovernmental Agreement on Federal Financial Relations (IGA FFR) aspired to improve public accountability for performance through new reporting requirements that focussed on the achievement of high level outcomes.

The IGA FFR was underpinned by National Agreements that set out the performance indicators and benchmarks that would inform the public on progress towards achieving the outcomes and objectives of the agreement. However, there were two problems with the way the IGA FFR was implemented that undermined its focus on accountability.

The first problem was with the 'rigorous focus on outcomes'. Fenna presciently highlighted what could happen if this was implemented in a way that interpreted State accountability as being to the Commonwealth rather than to their electorates:

In a relatively benign version, this would be a form of centrally facilitated yardstick competition. In a less benign form, the Commonwealth would assume responsibility for rewarding and punishing states for their performances.⁵⁵

This is essentially how the dynamic has played out in respect of a number of intergovernmental agreements. Using conditional grants under section 96 of the Constitution, the Commonwealth puts a sizeable and difficult-to-resist sum of money on the table as an inducement to States to shape their policies in ways that align with the Commonwealth's view of what the 'agreed' priorities should be in a particular area of activity. As States and Territories seek to secure reward funding, they surrender a degree autonomy to pursue their own preferences. As a result, this version of cooperative federalism can undermine the ability of the electorate to hold either level of government accountable for failure to deliver on their commitments.

A second problem is that many of the outcomes set out in agreements signed under the IGA FFR are vague and change can only be measured over a long period of time. Problems arise when there is a lack of adequate data to underpin the measurement towards the achievement of the

⁵⁵ A Fenna, 'Commonwealth Fiscal Power and Australian Federalism', *UNSW Law Journal* vol. 31(2), 2008, pp. 509-529.

outcomes. Also, there has been feedback from the States that the reporting costs have, on occasions, not been commensurate with the size of the payment received.

There is also the problem of being able to identify with certainty whether a particular policy or programme had a measurable impact on the outcomes. In that situation, the Commonwealth might be tempted to revert to input controls or reporting on outputs in some level of detail to assure itself that public money was being well targeted. Nevertheless, this was not the intention of the new arrangements. Such an approach undermines the focus on outcomes and reduces the incentives for innovation and continuous improvement in services.⁵⁶

Questions

- How can reformed roles and responsibilities result in improved accountability to voters?
- What level of accountability is required without imposing unnecessary reporting burdens and overly prescriptive controls?
- How can we develop better indicators and improve data quality?

(b) Subsidiarity, whereby responsibility lies with the lowest level of government possible, allowing flexible approaches to improving outcomes

Subsidiarity means that responsibility for particular areas should rest with the lowest form of social organisation capable of performing the function effectively. In general, families are likely to be the best people to make decisions about the kind of education their children should receive. Clubs and social associations are the best people to run their own cake stalls without intrusive regulation from government about the nature of the cakes being sold. Local governments are best placed to maintain local parks and organise waste collections. States and Territories are more likely than the Commonwealth to understand their communities' needs in a wide range of social services. The Commonwealth is best placed to organise the defence of the country and conduct diplomatic relations with foreign powers.

Even when there is agreement that a national goal for the achievement of some outcome should be set, subsidiarity allows States and Territories to adopt flexible approaches to the achievement of that outcome, as they are more likely to understand what is required to improve outcomes in their jurisdiction. Certain functions derive significant benefits from achieving economies of scale, while for other functions, diseconomies of scale occur if coordination is attempted centrally.

If the subsidiarity principle is to be given greater recognition, it is likely that some of the control over the States and Territories exerted by the Commonwealth would be given up. However, devolving responsibility to the lower level of government is not necessarily something that comes easily. In a situation where the Commonwealth is heavily involved in many areas of activity, and therefore is held politically accountable for outcomes and for the efficient expenditure of taxpayers' money, the temptation to trust less and control more can be very

⁵⁶ COAG Reform Council.

strong for ministers and public servants alike. So arguably subsidiarity will work best in combination with ‘clean lines’ of responsibility for particular areas of government activity.

This bias against trust in the current arrangements may have influenced the way the IGA FFR was implemented. The IGA FFR was supposed to herald a new era in which more funding was untied and the accountability focus moved to outcomes rather than inputs or activity. However, some commentators have questioned whether this has occurred: “while the tone and discourse of intergovernmental relations now resembled that of equal and trusting partners, the organisational culture, procedures, norms etc. governing what actually happened retained the institutional cynicism of previous experience”.⁵⁷ The COAG Reform Council considered the issue of cultural change significant enough that in its 2013 report on progress, it repeated an observation made in its first report in 2010:

Finally, it is worth reiterating the council’s belief in the importance of cultural change to embed reform. In its first report on the COAG reform agenda, the council noted:

Like all major public policy reform, the institutional reforms under the COAG reform agenda are fundamental and challenge conventional practices. Many of the key features of the new framework will require cultural change in the way all governments approach intergovernmental relations, policy development and service delivery—both across and within governments. (COAG Reform Council 2010, p. 14)⁵⁸

Advances in technology and their impact on service delivery are possibly relevant to the subsidiarity principle. For example, as more and more services and simple transactions between citizens and governments are capable of being delivered online, arguably it will be more effective for such services to be delivered through a single government portal that ‘joins up’ similar services across Commonwealth and State and Territory departments. There are other enablers for better service delivery to improve outcomes for citizens, such as the States and Territories having access to improved data, which could be collected and held by the Commonwealth. (Further discussion on data issues is at Section 8 below.)

Questions

- How should subsidiarity guide the allocation of roles and responsibilities in Australia?
- If that requires greater devolution of responsibility and resources, how can the necessary culture change be achieved?
- What is the impact of technology and new ways of delivering services (for example, services offered online) on the subsidiarity principle?

(c) National interest considerations

A number of factors have contributed to central governments’ greater involvement in the responsibilities generally regarded as the domain of regional governments, including the globalisation of markets, and more mobile populations which put pressure on the equity of service provision across jurisdictional borders. The social and economic imperatives of

⁵⁷ M McQuestin, ‘Federalism under the Rudd and Gillard Governments’, in P Kildea, et. al., *Tomorrow’s Federation: reforming Australian Government*, Federation Press, Annandale, 2012, pp. 19-20.

⁵⁸ COAG Reform Council, p. 11.

nationhood mean some issues need to be resolved in the interests of Australia as a whole, and these have tended to grow in number over time.⁵⁹

Sometimes a national approach is more appropriate than pursuing different approaches across the States and Territories. For example, economic considerations might require national regulation to make it easier for businesses to operate in more than one State or Territory. However, uniformity and consistency may come at the expense of diversity and competition between the States and Territories.

The IGA FFR currently sets out principles to “guide Commonwealth support for national reform in areas of State or Territory responsibility, where it:

- is closely linked to a current or emerging national objective or expenditure priority of the Commonwealth — for example, addressing Indigenous disadvantage and promoting social inclusion;
- has ‘national public good’ characteristics — where the benefits of the involvement extend nationwide;
- has ‘spill over’ benefits that extend beyond the boundaries of a single State or Territory;
- has a particularly strong impact on aggregate demand or sensitivity to the economic cycle, consistent with the Commonwealth’s macroeconomic management responsibilities; or
- addresses a need for harmonisation of policy between the States and Territories to reduce barriers to the movement of capital and labour”.⁶⁰

These principles, especially the first two, provide very wide, arguably limitless, scope for the Commonwealth to get involved in any areas of State or Territory responsibility. They set the bar for Commonwealth involvement very low.

A further consideration is Australia’s range of international obligations, including human rights obligations relating to health, education and housing. While many of these issues fall within areas of State or Territory responsibility, it is ultimately for the Commonwealth to ensure compliance with Australia’s international obligations.

Questions

- Should there be a ‘national interest test’? For example, when and in what areas should uniformity and consistency trump diversity and competition?
- What functions should be considered national functions? When is national action justified?
- Are the principles in the IGA FFR set out above still appropriate?

⁵⁹ K Wiltshire, ‘Australia’s New Federalism: Recipes for Marble Cakes’, *Publius* vol. 22, 1992, p. 174.

⁶⁰ Intergovernmental Agreement on Federal Financial Relations 2008, clause E21.

(d) Equity, efficiency and effectiveness of service delivery, including a specific focus on service delivery in the regions

The allocation of roles and responsibilities needs to encourage equitable, efficient and effective service delivery. The needs of the citizen should be front and centre.

Equity in service delivery means ensuring everyone is able to access services, recognising this may mean additional effort is required in some cases. Efficiency in service delivery means ensuring a service is being delivered by the most appropriate provider (which may or may not be government) in a way that delivers value for money. Effectiveness in service delivery means ensuring a service results in the intended outcomes for the people who access it. This will need to take into account equity and efficiency considerations, and should be measured in terms of outcomes.

Equity and efficiency are not the opposing principles they are sometimes seen to be. For example, if hundreds of thousands of simple service transactions and administrative processes (such as applying and paying for a driver's licence, or processing an unemployment benefit, or getting accreditation as small business for the purpose of fast-tracking payment by government departments) can be done more cheaply, then that can free up resources to devote to earlier, more cost-effective interventions for more disadvantaged citizens with more pressing needs.

Services that are very effective may also often be very expensive, and when making decisions about whether to spend taxpayers' funds on expensive service models, governments need to ask themselves what else could that money be spent on that might have a greater overall benefit for the community. These are often difficult decisions and ones where citizens' priorities may vary in different regions.

Reform of roles and responsibilities can and should open up possibilities for change that can result in outcomes for citizens being delivered more effectively at the same or lower overall cost, enhancing both effectiveness and efficiency. For example, reforms that involve greater contestability in service provision and greater citizen choice could be considered in the context of questions about the different roles of different levels of government as funders, purchasers, providers and regulators.

Questions

- How can reforming roles and responsibilities of different levels of government lead to services being better coordinated and delivered more efficiently and effectively (including those provided by local government)?
- How can the allocation of roles and responsibilities best ensure equitable service delivery?

(e) Durability

Durability means that any changes to the allocation of roles and responsibilities between different levels of government need to be appropriate for the long-term, and not subject to arbitrary change. Any changes to federal financial relations and governance arrangements also

need to be durable. A durable allocation of roles and responsibilities will also require governments to have certainty about appropriate revenues to fund their associated spending and service delivery responsibilities.

Once set, any change to the allocation of roles and responsibilities should be the result of an agreement by the Commonwealth and the States and Territories that the change is so important, so necessary, so vital to the long-term benefit of the country, that no individual First Minister can unilaterally decide to withdraw from the agreed structure without being seen to imperil the wellbeing of the nation in substantial ways. This was the situation in the 1990s under the reforms introduced through the National Competition Policy. Those reforms resulted in a quantum improvement in our national productivity and competitiveness. Arguably, reform of the Federation has similar potential.

While any new arrangement in relation to roles and responsibilities should be sufficiently robust and durable for the long term, there needs to be a process for taking into account changing circumstances that allows for any new arrangements to be amended through mutual agreement.

Questions

- How can changes to the allocation of roles and responsibilities be made more sustainable?
- How can flexibility to adapt to changing circumstances be built in to a 'durable' arrangement?

(f) Fiscal sustainability at both Commonwealth and State levels

The Commonwealth has been in fiscal deficit since the Global Financial Crisis (GFC), with the budget not expected to return to balance until 2018-19.⁶¹ Commonwealth net debt⁶² has risen sharply to 12.5 per cent of GDP in 2013-14, compared to negative 0.5 per cent in 2005-06.⁶³

The States and Territories are facing similar fiscal pressures. As a whole, the States and Territories are not expected to return to fiscal surplus until 2016-17. The States and Territories have been falling deeper into debt at the same time as the Commonwealth. Aggregate State and Territory net debt was 3.8 per cent of GDP in 2013-14, compared to negative 3.1 per cent in 2005-06.⁶⁴ The key driver of this trend in the last few years has been an increase in infrastructure spending, which coincided with a dramatic decline in operating surpluses due to depressed revenue in the wake of the GFC.⁶⁵ Other sources of revenue will also need to be looked at, such as user-charges or co-payments from people who use publicly subsidised services and can afford to make a greater private contribution to their cost.

⁶¹ Commonwealth of Australia, *Budget 2014-15, Budget Statement 3: Fiscal Strategy and Outlook*, Canberra, 2014.

⁶² Net debt is defined as the sum of selected financial liabilities (mainly borrowings) less selected financial assets (mainly cash, deposits and investments). It does not include superannuation-related liabilities.

⁶³ Commonwealth of Australia, *Budget 2014-15, Budget Statement 10: Historical Australian Government Data*, Canberra, 2014.

⁶⁴ Calculations using data from State budget papers and ABS Government Finance Statistics cat. no. 5512.0.

⁶⁵ R Carling, *States of Debt*, Centre for Independent Studies, Sydney, 2014, p. 10.

Fiscal pressures are projected to build gradually as Australia's ageing population trend accelerates in the next decade. This demographic change will have implications for economic growth and income per capita and will, in turn, reduce the rate of growth in the revenue base. Moreover, it will simultaneously increase pressures on pensions, aged care and health expenditure. (Further information on Australia's economic and fiscal context is at Appendix B.)

Other things being equal, these pressures will lead to a gradual deterioration in the fiscal position over time, requiring governments to run increasing deficits in order to fund expenditure, unless we are prepared to consider strengthening the revenue base, or a shift towards more personal responsibility for a range of costs among those able to bear them, or both. These variable and challenging threats to long-term fiscal sustainability will need to be addressed, so that governments remain equipped to respond to key policy drivers in our external environment.

In order to put public finances on a credible path to longer-term sustainability, governments have had to, and will continue to need to, make difficult and unpopular choices. In the context of the revenue and expenditure mismatch between different levels of government and the challenges of demographic change, whether governments could make better use of their efficient tax bases needs to be looked at, and this issue will be considered in the White Paper on the Reform of Australia's Tax System.

The interdependencies in intergovernmental finances, where revenue or spending decisions by one level of government have fiscal implications for other levels of government, will also need to be kept in mind. Fiscal sustainability for one level of government should not come at the expense of fiscal sustainability for other levels of government. This is one of the reasons why attention needs to be paid to the issue of vertical fiscal imbalance (VFI) which is discussed in Section 4. Not only should all levels of government have sufficient revenue to cover their expenditure responsibilities, but arguably they should also be responsible, and accountable to, their electorates for decisions to increase or decrease expenditure levels in their areas of responsibility, and for the associated increase or decrease in the required levels of revenue.⁶⁶

Questions

- Any reallocation of roles and responsibilities needs to be made fiscally sustainable at both Commonwealth and State and Territory levels. How can this be achieved?

⁶⁶ Fenna, citing I Jourard and PM Kongsrud, *Fiscal Relations across Government Levels*, OECD, 2003: "The prevailing view [in the public finance literature] has been that if governments rely extensively on revenue they are not responsible for raising, then they will not be in a position to 'tailor the supply of public goods to local citizens' preferences and willingness to pay."

3. Practical application of principles in the allocation of roles and responsibilities

As well as considering which principles should guide the allocation of roles and responsibilities, the White Paper will need to apply those principles to particular policy areas.

Health, education, and housing (including homelessness) are three important public policy areas where roles and responsibilities could be clearer. The White Paper will focus on these areas and will put forward a clear and credible pathway for clarifying roles and responsibilities. Issues papers on each of these will be released later in 2014.

The White Paper may also consider other policy areas where roles and responsibilities could be clearer: transport infrastructure, Indigenous affairs, justice, disability, welfare services, settlement services, family and parental support, disaster recovery, environmental regulation, adult and community education and youth transitions. These areas may be canvassed in the Green Paper, which will be released in the first half of 2015. To the extent practicable, the specific allocation of roles and responsibilities in these areas will be covered in the White Paper, including through the application of the principles discussed earlier in this Issues Paper. The White Paper will also consider formal mechanisms for COAG to use in making future decisions about the allocation of roles and responsibilities in any areas not fully covered by the White Paper. This goes to the issue of how COAG itself can be made more effective (see Section 7).

Questions

- Are the portfolio areas listed above the right areas for the White Paper to consider?
- Should other areas be within scope?
- How should the White Paper's six principles set out in Section 2 of this paper be applied to the allocation of roles and responsibilities?

In addition to considering the application of principles, the White Paper will also consider possible models for allocating roles and responsibilities between the Commonwealth and the States, including whether a government role is warranted at all. While these matters will be discussed more fully in the Green Paper, some broad models for allocating roles and responsibilities are canvassed below.

In some cases, governments may have a shared interest in a particular area, especially if there are 'spillover effects' from one level of government to another. For example, poorly operating juvenile justice and child protection systems (State and Territory responsibilities) have a major impact on social security expenditure (Commonwealth responsibility), and vice versa. As such, both levels of government have an interest in these policy areas. But shared interest does not necessarily require both levels of government to share responsibility.

(a) Competitive federalism

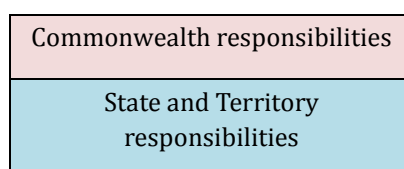
'Competitive federalism' most commonly describes an approach of horizontal competition between regional or sub-national governments (States and Territories in the Australian context). Under competitive federalism, the States and Territories are free to seek a competitive advantage over other governments at the same level, as opposed to pursuing harmonised national approaches. This diversity is seen as one of the strengths of federal systems, whereby policy experiments can lead to innovations that spread from one jurisdiction to another as their superior effectiveness is proven.

One of the common features of horizontal competition in federations is that sub-national governments can compete to attract mobile resources by reducing taxes on those resources. A consequence of this feature is that State and Territory tax bases can be eroded, further reducing their fiscal capacity to meet their expenditure needs.

Competitive federalism can also involve vertical competition between the Commonwealth and the States and Territories in areas of shared responsibility, although this can create duplication and overlap. For example, a central government might offer services (or fund private providers to offer services) also offered by regional governments, with citizens able to choose which service they use.⁶⁷

(b) Coordinate federalism

'Coordinate' federalism is where each level of government has discrete areas of responsibility separated by 'clean lines' with no overlap. Under this model, the Commonwealth and the States and Territories would have a clear split of roles and responsibilities. The intention would be to eliminate, as far as possible, shared responsibilities between the two levels of government:



For example, Commonwealth responsibilities could be limited to certain matters (such as those set out in section 51 of the Constitution), with the States and Territories responsible for all others. Alternatively, responsibilities could be 'swapped' between the two levels of government. The States and Territories could take on full responsibility for a policy area in which the Commonwealth currently has assumed a role. In return, the States and Territories could transfer full responsibility for another policy area to the Commonwealth. In practice, it is easier for the States to 'refer powers' to the Commonwealth than for the Commonwealth to give up to the States an area of responsibility assigned to it by the Constitution in section 51. See Appendix C

⁶⁷ See Fenna for a succinct summary and useful discussion of the concept of vertical competitive federalism. Also R Hollander, 'Rethinking Overlap and Duplication: Federalism and Environmental Assessment in Australia', *Publius* vol. 40(1), 2010, pp. 136-170, for an argument as how 'overlap and duplication' can, under certain circumstances, deliver competitive benefits to citizens.

for a description of various cooperative mechanisms that have been employed to allow the Commonwealth to take on a greater role.

The appeal of the 'coordinate' model is that all governments would be autonomous in their own areas of responsibility and there would be much less confusion about who is responsible for what. Accountability and efficiency would be enhanced. In practice, it would be difficult to achieve a clear spilt of responsibilities between both levels of government across all areas of government activity. It should be possible, however, to achieve 'clean lines' in more areas of government activity than currently, with other areas being shared between both levels of government. However, the interdependencies between policy areas (such as immigration and housing, or health and aged care) would mean that, while opportunities for cost- and blame-shifting should be reduced, they could not be eliminated altogether, as decisions of one level of government would continue to affect the other. Some form of cooperation and coordination will be needed to overcome this.

(c) Cooperative / collaborative federalism

Under this model, certain responsibilities are shared between the two levels of government. This model best describes current arrangements in Australia, where the Commonwealth and the States and Territories share responsibility for a number of policy areas (including health, education and housing). The Commonwealth's increased use of conditional grants to the States (through section 96 of the Constitution) has contributed to the high degree of shared responsibility in Australia. The 2008 Intergovernmental Agreement on Federal Financial Relations was intended to give expression to the ideal of cooperative federalism, with a series of national partnerships and agreements in health, education, skills, disability services, affordable housing and Indigenous affairs, setting out mutually agreed outcomes, targets and reporting requirements.

Sometimes, however, 'cooperative federalism' can veil or morph into 'coercive federalism'. This can occur where the Commonwealth requires States and Territories to implement certain policies, often using its fiscal power to do so. The extent of the vertical fiscal imbalance in Australia gives the Commonwealth considerable fiscal capacity to shape State and Territory behaviours in this way. This power may be exercised due to concern at what it sees as a lack of progress or specific responses by States and Territories in particular policy areas, or in response to demands from the public or other stakeholders to 'fix' a real or perceived problem without being concerned which level of government does it.

Shared responsibility with distinct roles

It is important to distinguish between responsibilities and roles. Governments can share responsibility for a policy area (e.g. health), but roles within that policy area (i.e. funder, policy developer, regulator and service deliverer) can be performed distinctly or on a shared basis.

In this variation on shared responsibility, governments have clearly distinct roles within an area of shared responsibility. For example, the Commonwealth could be the sole funder and policy setter, and the States and Territories could be solely responsible for the delivery of government

services (either directly, or through purchasing services from community or private sector organisations).

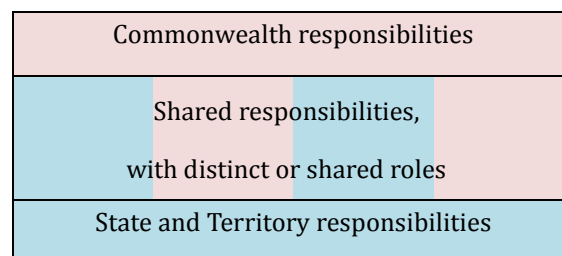
This approach allows both levels of government to be active within a single sector, without overlap in the specific roles they perform. This can minimise duplication and overlap. Achieving such a clear distinction in roles is a challenge. Often governments at both levels will have a role in funding and policy development, although the Commonwealth is rarely solely responsible for service delivery.

Shared responsibility with joint roles

In this variation, governments perform roles jointly within an area of shared responsibility. One or more roles (i.e. funding, policy development, regulation and service delivery) might be shared by both levels of government on mutually agreed terms.

For example, under the National Disability Insurance Scheme, the National Disability Insurance Agency is funded through a pooled funding arrangement, where both levels of government contribute an agreed share. The National Disability Insurance Agency is a Commonwealth corporate entity, legally separate from governments. It holds all funds contributed by the Commonwealth and the States in a single pool, manages scheme funds, administers access to the scheme and approves the payment of individualised support packages.

This model allows governments to work together in areas where, for a variety of reasons, a clean division of roles and responsibilities might not be possible. Pooled funding arrangements can reduce the risk of cost shifting where the pooling arrangements are transparent. However, where shared roles are not clearly defined, this can blur public accountability. Where shared roles continue, governments will need to find better ways to work together to address this.



Questions

- Under what circumstances and in what areas of government activity should governments share responsibility, and when should they not?
- If responsibility is to be shared in an area of government activity, what level of cooperation is necessary and how should it be achieved?

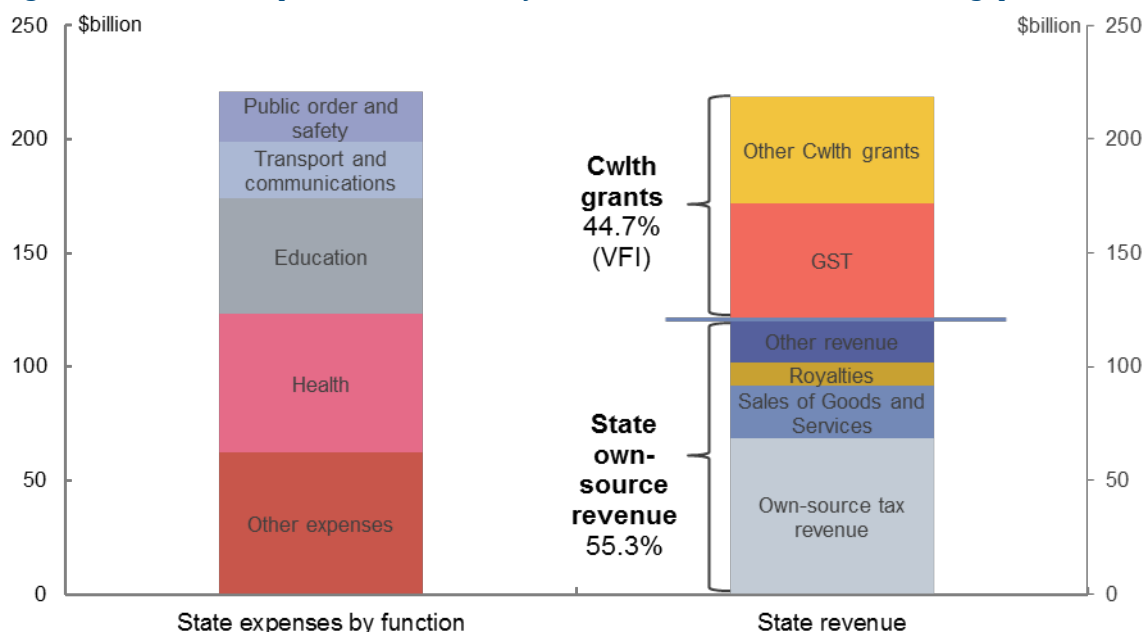
4. The revenue / expenditure mismatch: vertical fiscal imbalance

All federations have a degree of vertical fiscal imbalance (VFI): the national government raises more revenue than it needs to fund its own-purpose expenditure, and sub-national governments raise less revenue than they need to fund their expenditures, with the consequence being that the national government finances, through transfers to the regional governments, a proportion of those governments' expenditures. In Australia, VFI has grown largely as a result of High Court decisions on the interpretation of the Constitution in relation to taxation matters, and also because States have passed up opportunities to take back a greater role in levying income tax (see earlier Part on "Our Evolving Federation").

At the 2 May 2014 COAG meeting, the Prime Minister stated that through the White Paper process, COAG "should be capable of considering changes that will make transparency greater, will make accountability greater, and we'll try over time to ensure that the people who spend the money raise the money".⁶⁸

It is generally recognised that too high a degree of VFI can give rise to problems for accountability and transparency. Australia's degree of VFI is very high by international standards. Here, State and Territory and local governments together raise only 18 per cent of total tax revenue and the Commonwealth raises the remaining 82 per cent.⁶⁹ In Canada, by contrast, the central government raises only 45 per cent of total tax revenue.

Figure 1: VFI - States spend more than they raise; the Commonwealth fills the gap



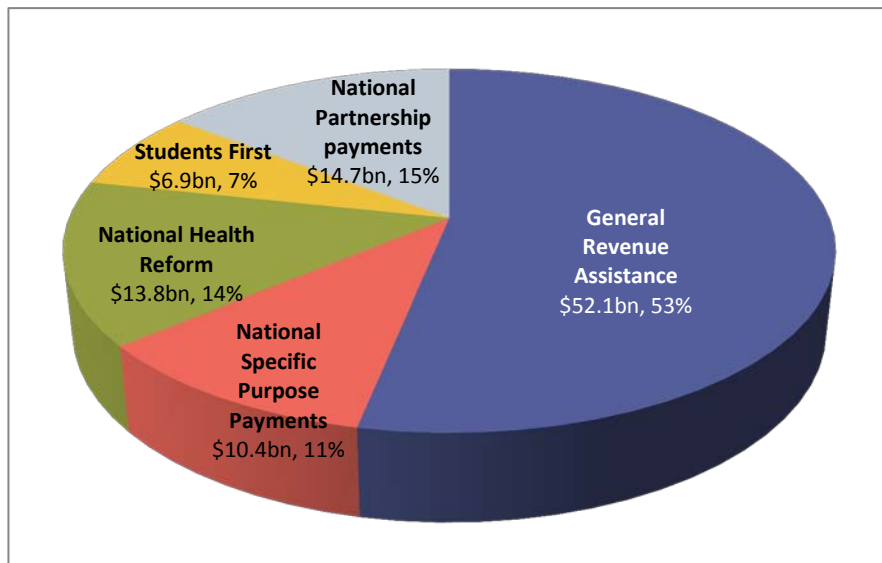
2013-14 data Sources: State budget papers, ABS. cat. no. 5512.0 and Commonwealth Budget 2014-15.

⁶⁸ COAG Press Conference 2 May 2014, <<https://www.pm.gov.au/media/2014-05-02/council-australian-governments-press-conference-parliament-house-canberra-0>>. In a similar vein, former Minister for Finance, Peter Walsh, stated that "a fundamental principle of responsible government in any system is that each government must raise the money it spends". P Walsh, *Labor and the Constitution: Forty Years On - Proceedings of the 9th conference of The Samuel Griffith Society*, 1997.

⁶⁹ Commonwealth of Australia, *Architecture of Australia's Tax and Transfer System*, 2008, p. 297.

Untied general revenue assistance (GRA), of which the Goods and Services Tax (GST) is the largest component, makes up the majority of Commonwealth payments to the States.

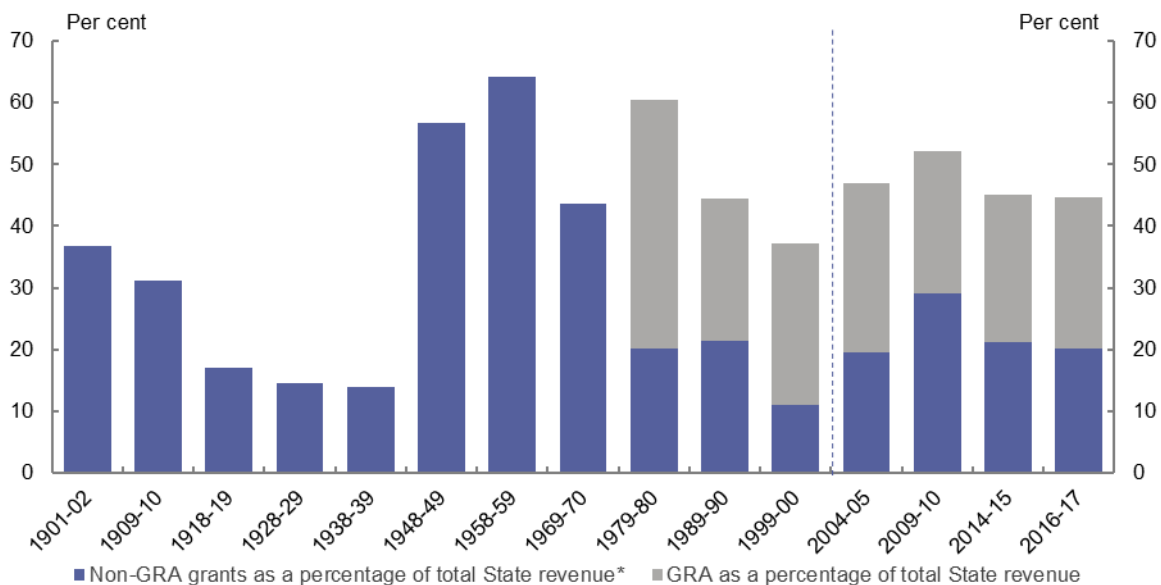
Figure 2: Payments to the States by type (2013-14)



Source: Data from Commonwealth Budget 2014-15

The degree of VFI has changed over time, but has been particularly marked since the States stopped collecting income tax during World War II. The high level of VFI has remained with the introduction of the GST in 2000, which, despite all the revenue being passed to the States and Territories, is classified as a Commonwealth tax and is collected by the Commonwealth.

Figure 3: VFI throughout Australian Federation



*Prior to 1979-80, this represents all Commonwealth grants as a percentage of total State revenue
 Note: The broken vertical line indicates the introduction of the GST in 2000. GST is within the GRA column.
 Source: To 1969-70 – Mathews and Jay, *Federal Finance: Australian fiscal federalism from Federation to McMahon*, 1997; 1979-80 onwards – ABS Cat. No 1301.0, Cat. No. 5512.0, Commonwealth and State and Territory Budgets.

VFI is often said to have negative consequences, including:

- reduced State and Territory autonomy through the use of tied grants;
- the undermining of State and Territory certainty over revenue allocations;
- reduced transparency and accountability to taxpayers due to the misalignment between States and Territories' revenue raising and expenditure;
- increased risk of unnecessary duplication and overlap; and
- weakened incentives for tax and microeconomic reform by the States and Territories.

On the other hand, there may be economic and other reasons why the Commonwealth should collect most taxes on a common policy and administrative basis, resulting in some persisting level of VFI. In this situation, the potential adverse consequences of VFI would need to be managed.

Previous attempts to consider substantial reform on the allocation of roles and responsibilities have often come to little. This is because the financial transfers involved from one level of government to another, in recognition of changes in related funding needs, have been too big to contemplate in the absence of a simultaneous reform to revenue-raising responsibilities. This time around, however, there is a good opportunity to effect change because revenue issues are on the table and will also be considered in the White Paper on the Reform of Australia's Tax System. This is necessary if the important issue of VFI is to be addressed. There are three possible correctives to the VFI issue:

- on the expenditure side, through the reallocation of spending responsibilities;
- on the revenue side, through increased access for States and Territories to own-source revenues, including through greater use of existing State and Territory tax bases; or
- a combination of both.

These matters will be canvassed in more detail in a separate issues paper on federal financial relations. There will also be links with the White Paper on the Reform of Australia's Tax System.

Questions

- What are the best ways to address the situation whereby there is a mismatch between what the Commonwealth and the States and Territories each spend on the one hand, and what they each raise in revenue on the other?
- To what extent is VFI really a problem and why?

5. Interstate equity: horizontal fiscal equalisation

Horizontal Fiscal Equalisation (HFE), a feature in many federations, is a process whereby the central government in a federation makes payments to the sub-national governments to reduce disparities in their fiscal capacities to provide public services to a similar standard to their citizens, at similar levels of tax burden on State taxpayers. It aims to take account of differences in the ability of States and Territories to raise revenue and the cost of service provision arising from differences in geography, demography, natural endowments and economies. However, the level of equalisation varies across federations, and within a federation can vary across time. In Australia, the practice of equalising fiscal capacities through various forms of fiscal equalisation has occurred since Federation, with full multi-state equalisation the current objective.

It could be argued that HFE at the State and Territory level is complementary to implicit equalisation in the Commonwealth sphere, providing a similar outcome to what would happen if Australia were a unitary system.⁷⁰ HFE could be described as recognising the arbitrary nature of State and Territory borders and factors beyond the control of governments.

Special grants to assist States with a lower fiscal capacity than others had been made since at least 1910. A greater desire for independent advice on how to assist these States resulted in the establishment of the Commonwealth Grants Commission (CGC) in 1933. From 1933 to 1981, the needs of claimant States were assessed against the average fiscal capacity of the 'standard' more populous States, usually New South Wales and Victoria. Special grants were then made to claimant States on this basis. From 1981, the system of full multi-state equalisation was progressively introduced, whereby the relative needs of each State and Territory are assessed against the average fiscal capacity of *all* States and Territories: an increased share for one State or Territory reduces the share of other States and Territories. This principle of fiscal equalisation has been upheld in intergovernmental agreements signed in 1999 and 2008, which both stipulate that HFE is to be the basis for distributing GST revenue amongst the States and Territories.

Currently the funds distributed to achieve HFE are the revenues raised from the GST. The distribution of GST required to achieve HFE is decided by the Commonwealth Treasurer each year, on the basis of advice provided by the CGC. The CGC defines HFE in the following way:

State governments should receive funding from the pool of goods and services tax revenue such that, after allowing for material factors affecting revenues and expenditures, each would have the fiscal capacity to provide services and the associated infrastructure at the same standard, if each made the same effort to raise revenue from its own sources and operated at the same level of efficiency.⁷¹

The CGC applies a formula that takes into account how the States and Territories on average raise and spend their revenue in order to determine what proportion of the GST pool they should receive for equalisation purposes. The proportion of the pool that each State and Territory gets does not equate to the amount that they would receive if the GST was distributed

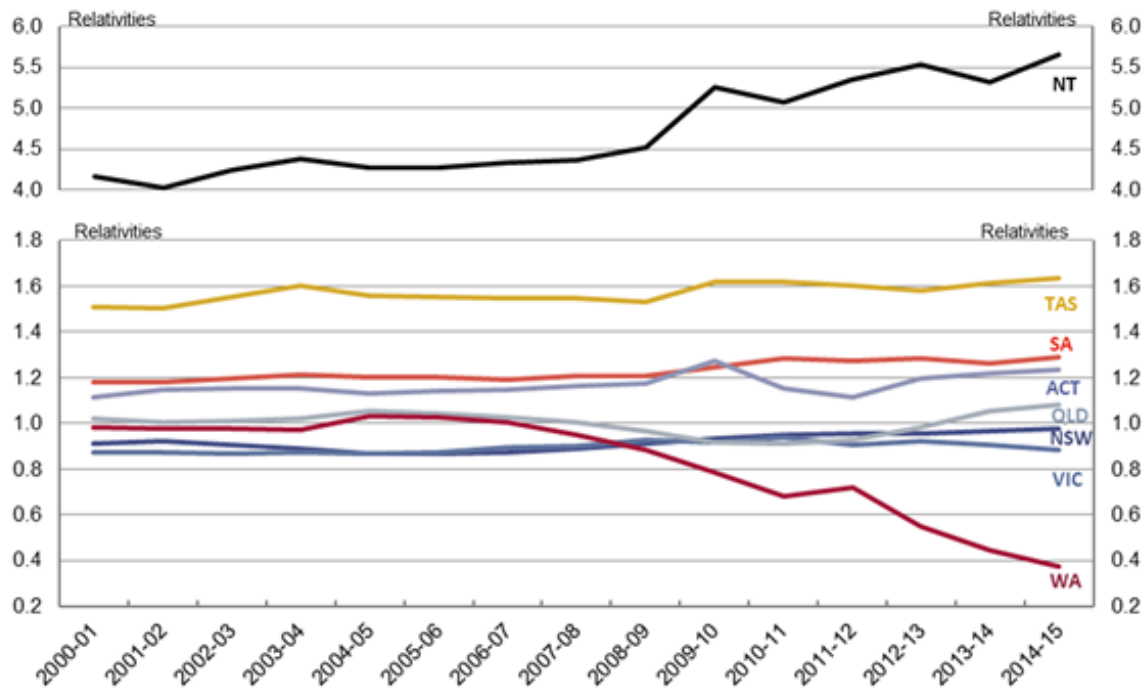
⁷⁰ Appendix B: Supplementary argument for HFE; in the 2012 *GST Distribution Review*, Interim Report, p. 147.

⁷¹ Commonwealth Grants Commission, *Report on Revenue Sharing Relativities*, vol. 1, Canberra, 2010, p. 34.

on a population (equal per capita) basis, and varies over time, depending on changing revenue raising capacities and assessed expenditure needs in each jurisdiction.

Figure 4 shows how GST relativities have changed since the introduction of the GST.

Figure 4: GST relativities (2000-01 – 2014-15)

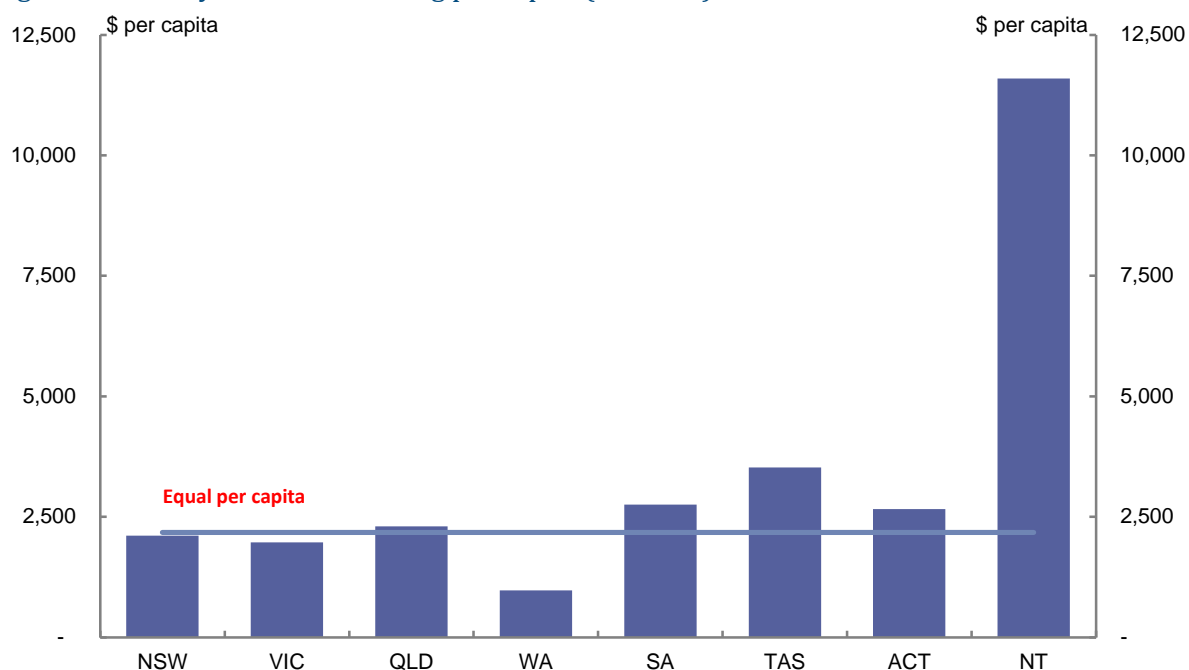


Source: Commonwealth Grants Commission Report on GST Revenue Sharing Relativities – 2014 Update

The relativity is a per capita weight assessed by the CGC for use by the Treasurer in determining the share of the GST revenue a State or Territory requires to achieve HFE. The relativities determine how much GST each State and Territory receives compared with an equal per capita share.

Figure 5 shows what the relativities mean in terms of how the GST ended up being distributed in 2013-14, with New South Wales, Victoria and Western Australia receiving a share of the GST that is less than an equal per capita share, while all other jurisdictions receive more than an equal per capita share to varying degrees. The Northern Territory receives by far the most on a per capita basis, due to the way the calculation is affected by its high per capita expenditure needs arising from the relatively high proportion of Indigenous people as a percentage of its small total population, spread over a large area.

Figure 5: State-by-State GST funding per capita (2013-14)



Source: Commonwealth Treasury, 2014

The White Paper will consider the most appropriate approach for ensuring that HFE does not result in individual jurisdictions being disadvantaged in terms of the quality of services they can deliver to their citizens. This principle needs to be applied in a way that gets the balance right between reducing disparities in fiscal capacities and not creating disincentives for States and Territories to improve their own revenue generation or to make the reforms necessary to improve the operation of their economies.

The White Paper will draw on previous reviews of HFE, including the final report of the 2012 GST Distribution Review. One of the key findings of the GST Distribution Review was that there was little or no evidence that HFE acts as a material disincentive to State and Territory tax reform, nor does it result in a loss of efficiency.⁷² The GST Distribution Review did not recommend any fundamental change to the GST distribution system in the short to medium term, finding the current system to be well established, internally consistent and working satisfactorily if the goal and definition of equalisation as currently set out is accepted.

However, the GST Distribution Review did put forward an argument for a longer-term reform vision of an equal per capita distribution of GST, with the Commonwealth providing top-up equalisation grants to the smaller States and Territories based on a guaranteed proportion of GDP.⁷³ The National Commission of Audit also recommended moving to an equal per capita

⁷² Commonwealth of Australia, *GST Distribution Review*, Final Report, Canberra, 2012, p. 18 (finding 9.1 on the relationship between HFE and efficiency).

⁷³ Commonwealth of Australia 2012, finding 12.1.

distribution of the GST, with the Commonwealth providing an additional grant to current recipient States and Territories to ensure that no State or Territory is worse off.⁷⁴

These matters will be canvassed further in a separate issues paper on federal financial relations to be released later in 2014. There will also be links with the White Paper on the Reform of Australia's Tax System.

Questions

- To what extent does equity in a federal system require financial resources to be redistributed between States and Territories to reduce disparities between them in their fiscal capacities to provide public services and infrastructure?
- What is the most appropriate approach for ensuring that HFE does not result in individual jurisdictions being disadvantaged in terms of the quality of services they can deliver to their citizens?
- How can HFE be structured to align incentives for States and Territories to improve their own revenue generation and to make reforms necessary to improve the operation of their economies?

⁷⁴ Commonwealth of Australia, *Towards Responsible Government – The Report of the National Commission of Audit*, 2014, p. 74 (recommendation 9).

6. Effectiveness and governance of federal financial relations

The White Paper will review mechanisms for the governance of the financial relationship between the Commonwealth and the States. The Intergovernmental Agreement on Federal Financial Relations (IGA FFR) has operated since 2009 and is the overarching framework for the Commonwealth's financial relations with the States and Territories. It sought to provide clarity about who is responsible for delivering government services, flexibility in the delivery of services, increased accountability to the public, and incentives for reform. A key element was a focus on the achievement of outcomes and outputs, while seeking to reduce Commonwealth prescriptions on how services are delivered.

There has been mixed success in achieving the IGA FFR's objectives.⁷⁵ It has not been effective in constraining the growth in the number of National Partnership Agreements and Implementation Plans, which sometimes have associated input controls that are arguably not in the spirit of the IGA FFR. Further, the National Health Reform Agreement and the National Education Reform Agreement were outside the framework set out by the IGA FFR. The COAG Reform Council concluded that the limited success was due to a failure to embed the IGA FFR's principles into intergovernmental processes following the agreements in 2008.⁷⁶

It is likely that, at the very least, significant improvements to the current framework for federal financial relations will be required. A revised framework will need to have a greater chance of giving expression to the durability principle (discussed in Section 2), while also retaining existing principles in the IGA FFR that have worked well. A key consideration will be finding the appropriate balance between the role of the Commonwealth in setting national goals, providing flexibility for States and Territories where they are responsible for service delivery, and appropriate accountability for the use of taxpayers' funds. It will also be important to ensure the framework is transparent.

While the White Paper will not be proposing any constitutional change, it is interesting to note that the World Bank, in assessing the success factors underpinning successful economic transitions for Eastern European countries, has concluded that "the principle of subsidiarity can best be safeguarded by anchoring the expenditure and revenue powers of sub-national governments in the constitution or in a similarly strong law".⁷⁷ This and other related matters will be explored in a separate issues paper on federal financial relations.

Questions

- How can the effectiveness and governance of federal financial relations be improved?
- What is the right balance between flexibility for States and Territories where they are responsible for service delivery, and appropriate accountability for the use of taxpayers' funds?

⁷⁵ COAG Reform Council, pp. 9-11.

⁷⁶ COAG Reform Council, p. 10.

⁷⁷ World Bank, *Fiscal Federalism in Switzerland: relevant issues for transition economies in Central and Eastern Europe*, 2005, accessed June 2014, <<http://elibrary.worldbank.org/doi/book/10.1596/1813-9450-3655>>.

7. Improvements to the Council of Australian Governments

The White Paper will consider ways to improve the operation of the Council of Australian Governments (COAG) to help make it a more strategic, consultative and cooperative decision-making forum.

COAG has operated for over 20 years as the peak intergovernmental forum in Australia. It emerged from Prime Minister Hawke's 'New Federalism' initiative and the associated special Premiers' Conferences of the early 1990s. COAG was established formally in 1992 to increase cooperation among governments in the national interest. COAG's members are the Prime Minister (who chairs the meetings), State and Territory Premiers and Chief Ministers, and the President of the Australian Local Government Association.

Often COAG, to the extent that it registers at all in people's awareness, is equated with the short meeting of the First Ministers, held at various intervals. As a meeting, it has been criticised for being too transactional and too adversarial, frequently involving disagreements over funding.⁷⁸

What COAG could conjure in the minds of Australians is the peak governance body for our federal system of government, an important forum of regular dialogue between the different levels of government, with an agenda that focusses on a small number of items of genuine national significance where cooperation is required.

The importance of having a robust framework for intergovernmental relations and dialogue is underscored by the fact that the essential character of the division of functions in the Australian Constitution is concurrent. Even if we are able to get agreement through the White Paper process about a clearer delineation of roles and responsibilities, there will remain many areas of shared responsibility.

Even if you could fix a neat and tidy division of roles on paper in, say, housing policy, difficulties would almost certainly arise because different housing groups or clients also have other related needs and interests and demands on government, and they would bring their demands to other levels of government that have other responsibilities ... But there are no constitutionalised mechanisms for government pooling executive authority to deal with these shared functions; they muddle along and try to co-operate in an ad-hoc way to cope with these overlaps and duplications.⁷⁹

This highlights the need for federations to have systematic intergovernmental relations, which play a vital role in bringing governments together. As the Victorian Parliament's Federal-State Relations Committee found in 1998, "In a federation as concurrent in structure as Australia's, effective intergovernmental relations are essential to the successful management of the inevitable overlap between the activities of governments".⁸⁰

COAG Councils, which are the bodies comprising Commonwealth and State and Territory Ministers in particular portfolios, are also part of COAG's architecture. Ministers should be able

⁷⁸ M McKenna, 'Federal bullying must end', *The Australian*, 13 April 2013.

⁷⁹ M Painter, Minutes of Evidence, Victorian Parliament's Federal-State Relations Committee Report on *Australian Federalism: The Role of the States*, 1998, pp. 16-17.

⁸⁰ Victorian Parliament, Federal-State Relations Committee Report on *Australian Federalism: The Role of the States*, 1998, p. 17.

to make decisions without referring matters to COAG that do not need First Ministers' attention. For a variety of reasons, the COAG agenda has in recent years been taken up with matters that, arguably, could be more appropriately dealt with at the level of Ministerial Councils, such as food regulation voting arrangements. This means that issues can take much longer to resolve than necessary.

COAG needs to be selective about the issues it deals with. Just because a particular problem is nation-wide does not necessarily mean the Commonwealth government has to get involved in the solution. For example, harmonisation of State and Territory regulation will not always be the answer. Where greater consistency is required, States and Territories could consider opportunities to facilitate mutual recognition.

Questions

- How could COAG be strengthened to better support Australia's Federation?
- Can the structures supporting COAG, such as COAG Councils, be improved?

8. Performance reporting, transparency and data arrangements

All Australian governments should be able to get on with delivering their responsibilities, but with appropriate levels of accountability to the Australian people through their respective parliaments.

A key benefit of federalism is the capacity for individual jurisdictions to experiment in methods of legislation, administration and service delivery to identify the best way forward, which can be particularly beneficial in a rapidly changing society, or in developing new solutions when the old ones are no longer working.⁸¹

Comparing different approaches to determine what works requires evidence and data. However, the multiplicity of public performance reporting and data collection bodies, and the limitations and accessibility of datasets between governments, remain of concern to all jurisdictions. The White Paper will consider performance reporting, transparency and data arrangements for the Federation. A key objective is to ensure appropriate levels of accountability without imposing unnecessary reporting burdens on governments. Where possible, data should be reported once but used often.

Reform of the Federation provides an opportunity to build a more robust, comprehensive and transparent data collection and performance reporting framework across all levels of government. Performance reporting needs to be transparent, accessible and easily understood by the public. With the closure of the COAG Reform Council on 30 June 2014, the White Paper is an opportunity to consider new arrangements for ongoing performance monitoring, including whether there should be independent assessment of governments' performance.

⁸¹ G Walker, *Rediscovering the Advantages of Federalism*, Lecture in the Department of the Senate Occasional Lecture Series, 19 March 1999.

Another issue that needs consideration is how to make better use of the vast amount of data already collected by governments to improve outcomes, and how there can be better data sharing across governments, both horizontally and vertically, particularly given the increased opportunities for data sharing in the digital information age.

Another major problem affecting performance reporting is the variable quality of much of the data collected and the lack of data comparability across jurisdictions in areas of activity that are largely similar. There are challenges with collecting comparable data from multiple jurisdictions operating in a competitive environment and, as previously mentioned, there is the problem of attribution. That is, how can we be sure that a particular policy intervention now is having an effect on an outcome measured in twenty years' time, given the influence of many other factors?

The issue of improvements to the reporting framework will be covered in the forthcoming issues paper on federal financial relations, and will reflect lessons learnt from the Intergovernmental Agreement on Federal Financial Relations and, in particular, the importance of clear outcome measures and their link to measurable outputs.

The reform process also provides an opportunity to contribute to the modernisation of our national data infrastructure. For example, measurement of outcomes can be more successfully achieved by combining administrative and survey data, rather than relying on administrative data alone, although this may be costly and involve long-term commitment by all jurisdictions. Additionally, policy interventions can be better designed when informed by a richer evidence base this kind of improvement could deliver.

Questions

- What level of performance reporting is required to provide an appropriate level of public accountability?
- Who should monitor performance?
- How can the costs of data collection be reduced and data gaps addressed?
- How can we make better use of the data currently collected by governments to improve outcomes for citizens?

APPENDIX A: FEDERALISM – WHAT IS IT AND WHY IS IT IMPORTANT?

Key points

- Federalism is a system of government where powers are distributed between a central government and regional governments. There are many federations and all are different.
- Federalism has a number of benefits for citizens, including bringing government closer to the people and enhancing democracy.

Characteristics of federalism

There are more than twenty five federations in the world, including Argentina, Australia, Brazil, Canada, Germany, India, Malaysia and the United States of America, and the number is growing.⁸² All federations are different. Some have very few regions while others have many. Some have clear divisions of power, while others have significant overlap between the different levels of government. There are almost as many varieties of federal systems as there are federations. There are, however, some characteristics common to most federations:⁸³

- (i) the *centre* (comprised of a set of institutions) which has authority over the whole of the nation (in Australia, this is the Commonwealth Government);
- (ii) *regions*, which have authority over a particular geographic area (the States and Territories);
- (iii) the distribution of power between the centre and the regions (the allocation of roles and responsibilities between the Commonwealth and the States and Territories);
- (iv) a constitution (usually written) which cannot be amended by the centre or any region acting solely on its own (the *Australian Constitution*);
- (v) rules which determine the procedure for resolving conflict between the centre and the regions (relevant parts of the Constitution); and
- (vi) judicial authority for the resolution of conflict (High Court of Australia).

Another characteristic common to many federations is an imbalance of fiscal power between the central government and regional governments, which results in the central government transferring some of the revenue it collects to the regional governments so they can deliver their responsibilities.

⁸² A Twomey and G Withers, *Federalist Paper 1: Australia's Federal Future*, Council for the Australian Federation, 2007, p. 19.

⁸³ G Sawyer, *Modern Federalism*, Watts, London, 1969, pp. 1-2.

Types of federalism

The terms 'layer cake federalism' and 'marble cake federalism' are sometimes used to describe two different types of federalism.⁸⁴ In layer cake federalism (also called 'coordinate federalism'), each level of government has discrete areas of responsibility separated by 'clean lines' with no overlap. However, the complexity of modern society and a modern economy and the effects of globalisation mean that all federations have significant, albeit different, levels of overlapping responsibility. The term 'marble cake federalism' describes the situation where many responsibilities are shared by the levels of government, and where governments cooperate to achieve common objectives. 'Collaborative federalism' and 'cooperative federalism' also describe this type of federalism. Almost 114 years after Federation, the Australian Federation now resembles more of a marble cake than a layer cake. There are many responsibilities that overlap between the Commonwealth and the States and Territories, with health and education as key examples.

Benefits of federalism

Federalism is regarded as one of the best systems for ensuring government is close to the people while also dealing with the competing pressures produced by globalisation. Four major benefits of federal systems are summarised below.

- (i) Regional governments are 'closer to the people'. Regional governments are arguably more within the reach of their communities than the central government and are more responsive to the specific needs of their communities, allowing policies and services to be customised.⁸⁵
- (ii) Checks on the power of government. Federalism divides and limits power. It supports pluralist democracy by rejecting 'majority rule' across the whole federation. Regional diversities (including economic and cultural differences) can be accommodated, which strengthens the overall unity of the nation.
- (iii) Competition between governments (competitive federalism) can lead to policy innovation and better services, as individual regions experiment with social, economic and political policies which might be adopted in other jurisdictions if they are successful. There are a number of instances where the Australian States have developed innovative policies that have then been adopted nation-wide.⁸⁶ This can also lead to greater choice and diversity among jurisdictions. Theoretically, people can 'vote with their feet' by moving to a different jurisdiction within the federation if they believe their wellbeing will be enhanced by doing so.
- (iv) Democracy is enhanced. Federalism increases participation in the democratic process, as people are able to elect representatives in more than one government,

⁸⁴ Term coined by US political scientist Morton Grodzins (see M Grodzins, *The American System*, Rand McNally, Skokie, 1966, p. 7).

⁸⁵ However, in a large country like Australia, often rural and regional communities can feel just as disconnected from the concerns of a State and Territory government as they do from the Commonwealth Government.

⁸⁶ For example Victoria first introduced compulsory wearing of seat belts in automobiles in 1970.

can vote for different parties at the regional and national levels, and can lobby more than one government.

Competition between the States and Territories (such as financial incentives to draw investment away from one State or Territory to another) may benefit one State or Territory, but might ultimately cost the national economy. Having different States and Territories competing with each other overseas for international investment can leave potential investors confused and possibly wary of investing in Australia.⁸⁷ A related issue is the so-called 'race to the bottom' on mobile State and Territory tax bases, whereby States and Territories compete away their efficient tax bases (for example, on payroll tax) in order to attract investment. This can get to the point where the overall benefit to the State or Territory is marginal at best, and perhaps non-existent. It also means businesses are making decisions on where to invest on financial, rather than economic considerations, which leads to less economic benefit overall.

Australia and other federations

In Australia, the Constitution gives the Commonwealth Parliament certain legislative powers. These powers are mainly set out in section 51 of the Constitution and include defence, external affairs, corporations and postal and telecommunications services.⁸⁸

Subject to State constitutional prohibitions, each State Constitution gives the respective State Parliaments the power to make laws on any subject of relevance to that particular State. The States primarily regulate and provide important public services such as hospitals, education, police, public housing and public transport. However, State Constitutions must be read in the context of the Australian Constitution, which gives some powers exclusively to the Commonwealth Parliament. Under section 51 of the Constitution, the Commonwealth and States have a number of concurrent powers. The Constitution also makes it clear that if both the Commonwealth and a State have made laws in a certain area, then to the extent that they are inconsistent with one another, the Commonwealth law overrides the State law. Other parts of the Constitution, such as the trade and commerce power, the corporations power, or the power to give conditional funding to the States, enable the Commonwealth to become involved in areas not listed under section 51.

How does Australia's model of federalism compare with other federations around the world?

United States of America

The Australian model of federalism was influenced by that adopted in the United States, particularly in the allocation of powers between the federal government and the states. The United States constitution does not comprehensively list all of the powers of the states and Congress. Rather, Congress is conferred with a set of responsibilities, and all other powers remain with the states. Over time, the role of the federal government in the United States has

⁸⁷ Business Council of Australia, p. 6.

⁸⁸ Other areas of the Constitution, such as section 96, allow the Commonwealth to be involved in areas which are not the subject of a specific legislative power. Section 96 provides for the Commonwealth to give conditional funding to the States.

expanded. Contemporary American federalism is characterised by a similar degree of overlapping responsibilities as Australia.

The United States has no formal system of fiscal equalisation between the states. However, under the Grants-In-Aid system there are more than 1,100 federal aid programmes for the States, with each programme having its own rules and regulations.⁸⁹

Canada

Canada was the first country to mix a federal system with Westminster-style parliamentary democracy. In its early years, Canada was a highly centralised federation. Unlike the constitutions of Australia and the United States, Canada's constitution (*Constitution Act 1867*) sets out the powers assigned exclusively to the provinces, such as education. A certain number of powers are given exclusively to the federal government, such as national defence.⁹⁰ Unlike in Australia, there is no federal department of education. A small number of powers, such as agriculture, are shared between the two levels.

The powers assigned to the provinces were intended to be limited. However, over time Canada has become highly decentralised and, in contrast to Australia, is now regarded as one of the most decentralised federations. This has been due to judicial decisions favouring the provinces, popular support for the assertion of provincial rights and the expansion of social policies (which are largely the responsibility of the provinces). Quebec nationalism has also encouraged decentralisation, from which other provinces have benefited.⁹¹

Canada has two large fiscal transfers (the Canada Health Transfer and the Canada Social Transfer), through which the federal government supports health and other social programmes administered by the provinces. Equalisation payments are also mandated in the constitution, which allows payments to be made to "less prosperous provinces to ensure their public services are comparable with those in more prosperous provinces at reasonably comparable levels of taxation".⁹² The equalisation payments are a revenue-only consideration that do not take into account the expenditure requirements of the provinces. Canada's external territories have a separate programme which recognises both their revenue raising capacities and expenditure needs.⁹³

Germany

The German constitution (*Grundgesetz*, or the Basic Law for the Federal Republic of Germany) allocates powers between the federal government and the *Länder* (states). Certain powers are allocated to the federal government. Similar to the Canadian constitution, the German constitution lists exclusive federal powers and powers shared with the *Länder*. The unallocated residual powers remain at the *Länder* level. The German model essentially adopts a division of

⁸⁹ J Clemens and N Veldhuis, *Federalism and Fiscal Transfers: Essays on Australia, Germany, Switzerland and the United States*, Fraser Institute, Vancouver, 2013, p. 6.

⁹⁰ The Canadian federal parliament has a residual power to make laws for the 'peace, order and good government', although this is seen as more of an emergency power than a general power to make laws on any subject.

⁹¹ D Cameron, 'Canada' in *Handbook of Federal Countries*, Forum of Federations, 2005, p. 109.

⁹² Clemens and Veldhuis, p. 2.

⁹³ Commonwealth of Australia, *GST Distribution Review*, Final Report, 2012, Chapter 1.

functions rather than a division of policy areas. Legislative powers are highly centralised, with the administration of laws and the delivery of services being comparatively decentralised. There are very few examples of direct federal administration of services.

An interesting feature of German federalism is its financial arrangements: the income tax base and other tax bases are shared between the levels of government and the shares are reviewed periodically to see whether the evidence suggests a change in the percentage going to each level of government in the context of its circumstances.⁹⁴

Switzerland

Switzerland's federation is defined by linguistically and culturally diverse regions. Federal powers are listed in the Swiss constitution, which has been subject to two comprehensive transformations since it was originally agreed in 1848. Like the German federation, the federal government in Switzerland does not implement much federal law, which is mainly left to the cantons (equivalent to Australia's States). The Swiss federation is more decentralised than centralised, with the federal government largely dependent on the cantons for the administration of its legislation.

In the first decade of this century, Switzerland substantially altered the fiscal relations between the federal government and the cantons. The key theme was 'disentanglement', whereby responsibility for a number of areas including education, social security and transport infrastructure, which were previously areas that had joint funding and regulation, were allocated either entirely to the federal or the cantonal level of government. Since the federal government was funding its share of joint tasks through a set of intergovernmental grants, disentangling resulted in a decrease of grants by about 40 per cent.⁹⁵

⁹⁴ K Wiltshire, 'Simple tax formula will put everything back in place', *The Australian*, 16 May 2014, p. 16.

⁹⁵ H Blochliger and C Vammalle, *Reforming Fiscal Federalism and Local Government – Beyond the Zero-Sum Game*, OECD, Paris, 2012.

APPENDIX B: ECONOMIC AND FISCAL CONTEXT

Key points

- There are a number of risks to continuing economic growth, including the ageing population.
- Australia's ageing population trend is expected to accelerate in the next decade. This is expected to have implications for the rate of growth in the tax revenue base, while increasing the pressure on pensions, aged care and health expenditure.
- The falling proportion of GST revenue relative to Gross Domestic Product (GDP) is partly a result of increased savings and partly a result of increased relative consumption of goods and services that are not subject to the GST, and is contributing to a situation where State and Territory expenditure growth is exceeding the growth in the GST revenue that is passed onto the States and Territories.
- The effect of the ageing population on aged care and health care costs, as well as increased demand for services for people with disability and the provision of infrastructure, is expected to add to the expenditure burden on all levels of government.
- Given their central role in the provision of these services and infrastructure, the States and Territories will be particularly affected. Therefore, there will need to be a frank discussion about community expectations of governments, and what governments can realistically do, given their tax bases.

Australia has had 22 years of continuous economic growth, despite external shocks such as the Asian Financial Crisis in 1997, the bursting of the 'dot-com' bubble in 1999-2001, and the Global Financial Crisis (GFC) of 2008-09. During this period, growth in real incomes per person has been almost continuous, with only a modest dip at the height of the GFC, and sluggish recovery in the developed economies thereafter. However, there are a number of risks to continued economic growth and, in turn, our standard of living: poor productivity growth performance, declining terms of trade; and the ageing population. These risks will also affect the fiscal sustainability of public finances.

A small fish in a big pond: the importance of productivity growth and the terms of trade

Australia faces an abundance of opportunity in Asia. But we also face many competitive challenges to realise these opportunities. Improving Australia's international competitiveness means raising productivity growth performance, so that we can compete on the global stage for Asian demand for agricultural produce, services such as education, and high-end manufacturing goods, on the basis of both cost and quality. Education, research and innovation play key roles in national productivity growth.

However, the rate of Australia's multi-factor productivity⁹⁶ growth has declined since the turn of the century, and is currently negative.⁹⁷ While this has been driven to some degree by unprecedented mining investment and the time lags that exist between mining investment and production, the slowdown in productivity has been broad-based across industries, suggesting that other economy-wide factors are at play.

Australia's terms of trade⁹⁸ peaked at unparalleled heights in 2011, but have since declined as the prices for key commodity exports have eased. Commonwealth Treasury modelling suggests that falling terms of trade will be a significant drag on Australia's national income growth over the medium term.⁹⁹

Productivity discussions tend to focus on the 'market sector' of the economy where goods and services are traded and more easily valued in monetary terms. However, it is also important to consider the government sector. According to the Australian Bureau of Statistics there are over 1.8 million public sector employees making up over 16 per cent of total employed persons. Total wages for public sector employees totalled over \$133.8 billion in 2012-13.¹⁰⁰ The government sector therefore has a significant bearing on national productivity performance.

Efforts to improve public sector productivity should not be overlooked. The last major, successful, effort to improve public sector productivity on a national scale, which flowed through to strong economic growth, was the National Competition Policy. This relied on successful collaboration between the Commonwealth and the States.

Rationalisation of the roles and responsibilities through reform of the Federation has similar potential to drive public sector productivity improvements by enhancing transparency and accountability and by reducing overlap and duplication and streamlining and reducing regulation. There is also the opportunity for driving greater contestability in the delivery of public services if, in the process, governments that previously were the monopoly or dominant provider of a service in a particular market, decide to take on a purchasing role rather than a provider role.

Australia's ageing population

Australia's ageing population trend is expected to accelerate in the next decade. The proportion of the population aged 65 and over is expected to increase from 13.5 per cent in 2010 to nearly 20 per cent in 2030.¹⁰¹ The 2010 Intergenerational Report projects that, by 2050, there will only be 2.7 people of working age to support each Australian aged 65 years or over, compared with

⁹⁶ Productivity measures examine the efficiency of producing outputs, given available inputs.

⁹⁷ M Parkinson, *Fiscal sustainability & living standards – the decade ahead: address to the Sydney Institute*, 2 April 2014, p. 5.

⁹⁸ The terms of trade measures the relationship between the prices a country receives for its exports and the prices it pays for its imports.

⁹⁹ Parkinson, p. 7.

¹⁰⁰ Australian Bureau of Statistics, *Employment and Earnings, Public Sector, Australia, 2012-13*, cat. no. 6248.0.55.002.

¹⁰¹ Commonwealth of Australia, *Australia to 2050: future challenges, Intergenerational Report 2010*, Canberra, 2010, p. 10.

5 working age people per aged person in 2010, and 7.5 working age people per aged person in 1970.¹⁰²

This demographic change will have implications for economic growth and income per capita, and will, in turn, reduce the rate of growth in the revenue base. Moreover, it will simultaneously increase pressures on pensions, aged care and health expenditure. It again emphasises the need for greater public sector efficiency.

Fiscal pressures on Australian governments

Despite continuous economic growth for over two decades, the Commonwealth has been running a fiscal deficit since the GFC, and the budget position deteriorated significantly between 2012-13 and 2013-14. The deficits of recent years have been primarily driven by the GFC and the associated government response. However, the structural component of the projected deficit in future years partly reflects a reduced tax base, and increased expenditure levels on long-standing programmes.¹⁰³ Addressing such significant structural factors requires difficult and unpopular decisions to be made.

Increased expenditure levels

The ageing population is expected to add to government expenditure on aged care and health. Rising health costs are also being driven by the growth in medical expenditure per capita, which is driven by advances in technology and increased public consumption of health services.¹⁰⁴

The increase in the number and proportion of aged persons will drive age-related pensions to grow at a rate faster than GDP. Australia's growing and increasingly mobile population will need to be supported through adequate infrastructure, which includes economic infrastructure such as transport, but also health and social infrastructure. There are also pressures on social policy spending other than health, such as in the areas of schools, tertiary education (based on the changing nature of the labour market and increasing demand for higher level qualifications and skills) and disabilities support. Many of these factors lead to an increasing expenditure burden on the States and Territories in particular, given their key role in infrastructure provision and social service delivery.

A slowdown in income per capita growth may prompt Australians to look increasingly to government of all levels for support, placing even further strain on government budgets. This may exacerbate the gap between community expectations of governments, and what governments can realistically do fiscally. This gap between community expectations of government services and the taxes that the community are prepared to bear will need to be addressed. This will require a frank, community-wide discussion but one of the barriers to that discussion is overlapping government responsibilities and the resulting lack of clear accountabilities.

¹⁰² Commonwealth of Australia 2010, p. viii.

¹⁰³ However, it is noted that fiscal drag will, if left untouched, eventually put the budget back into surplus.

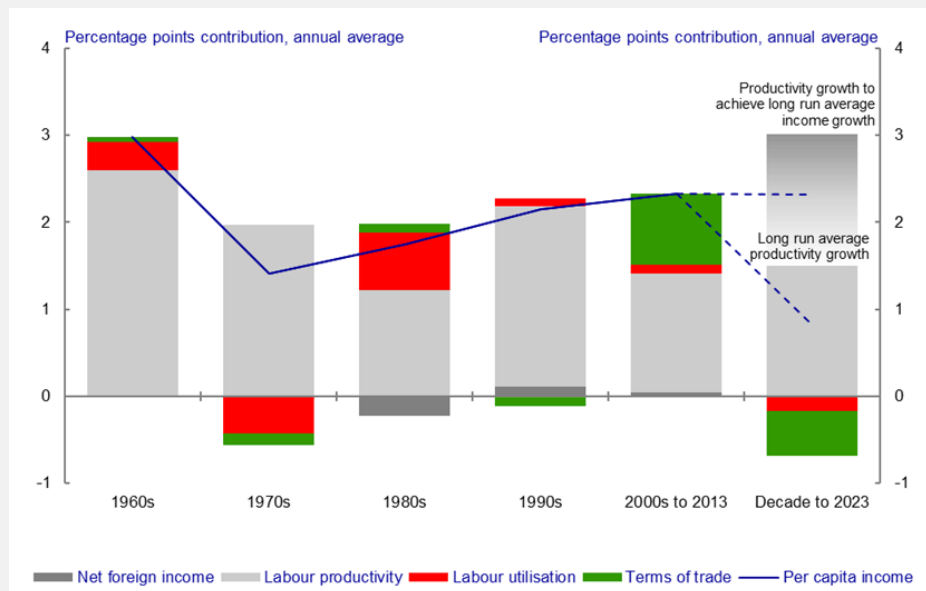
¹⁰⁴ J Daley, C McGannon & A Hunter, *Budget Pressures on Australian Governments 2014*, Grattan Institute, Melbourne, 2014.

Box 1: Contributions to annual income growth

The following chart shows that labour productivity has consistently been the most significant source of income growth since the 1960s. However, over the past decade or so, it has been the dramatic rise in the terms of trade which has maintained growth in gross national income as productivity growth has waned. Over the next decade, the decline in the terms of trade is expected to detract from growth in incomes. This negative impact will be compounded by a declining contribution from labour utilisation as the population ages.

This leaves labour productivity growth as the key to continued income growth. If labour productivity grows at its long-term average, then per capita incomes would grow on average over the coming decade by around 1 per cent per year, or less than half of the rates to which Australians have become accustomed. If growth in annual income were to grow at its historical average, we would need sustained productivity growth of around 3 per cent – around double what has been achieved since 2000.

Figure: Contributions to annual income growth



Note: Income refers to real gross national income. Source: Parkinson 2014, ABS Cat. No. 5204.0 and Commonwealth Treasury

Reduced tax base

Revenue as a share of GDP has tended to fall or grow only slowly since the 2000s. There has also been a general decline in GST receipts as a share of GDP between 2003 and 2012, due to the decline in consumption as a share of domestic income, a corresponding increase in household savings and a change in the composition of household expenditure to increasingly favour expenditure that is exempt from the GST: private health, private education, home ownership and

rent, and fresh food. The growing use of international purchases over the internet has also tended to reduce GST revenues as these transactions are difficult to tax.

Having said this, the recent Commonwealth Budget is forecasting GST revenues to improve over the forward estimates, with the ratio of GST-to-GDP expected to reach 3.4 per cent by 2017-18, the highest since 2007-08. In fact, growth in GST revenues is expected to outstrip that of GDP over the forward estimates, due to GDP growth being held back by declining mining investment.

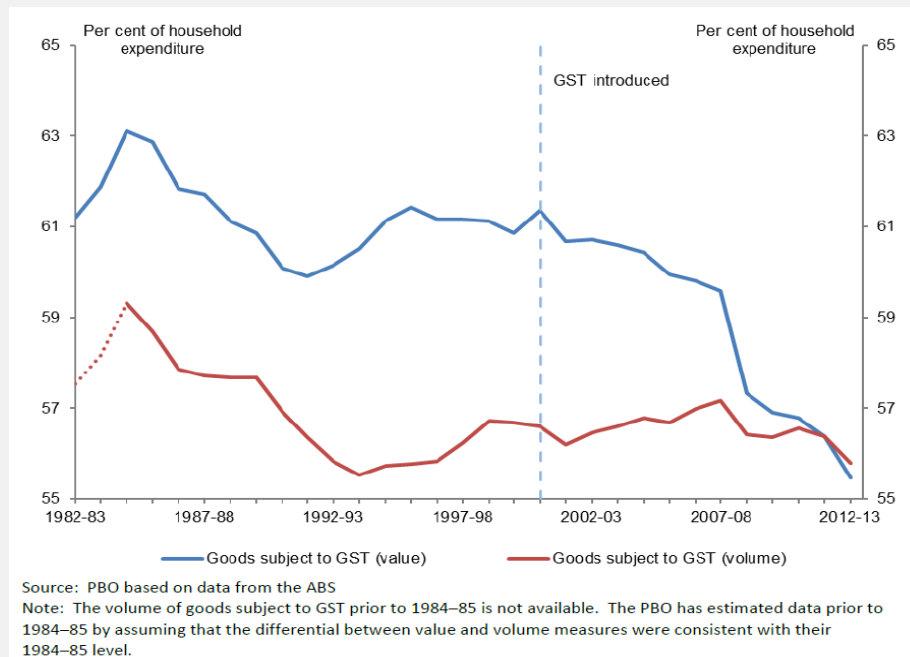
The diminishing returns of GST revenue relative to total consumption have contributed to a situation where State and Territory expenditure is expected to grow at a much faster rate than GST revenues.¹⁰⁵ As State and Territory expenditure will outstrip both GST and GDP growth in future years, this points to the need for governments to look at how that spending growth can either be constrained or funded.

¹⁰⁵ Price Waterhouse Coopers, *Protecting prosperity: Why we need to talk about tax*, 2013, p. 24.

Box 2: Proportion of household expenditure subject to GST

The following chart shows that the share of household consumption expenditure subject to the GST has fallen significantly since the introduction of the GST, from around 61 per cent in 2001-01 to less than 56 per cent in 2012-13. It is notable that the *value* of consumption subject to GST is not reflected in the *volume* of consumption subject to GST, which has remained relatively stable over the period. This means that the reduction in consumption subject to GST has been driven primarily by the prices of goods and services excluded from the GST rising faster than the prices of goods and services subject to the GST. Another notable feature of the chart is the big decline in 2008-09, which directly relates to the increase in household savings in that year, with households cutting back on discretionary spending.

Figure: Proportion of household expenditure subject to GST

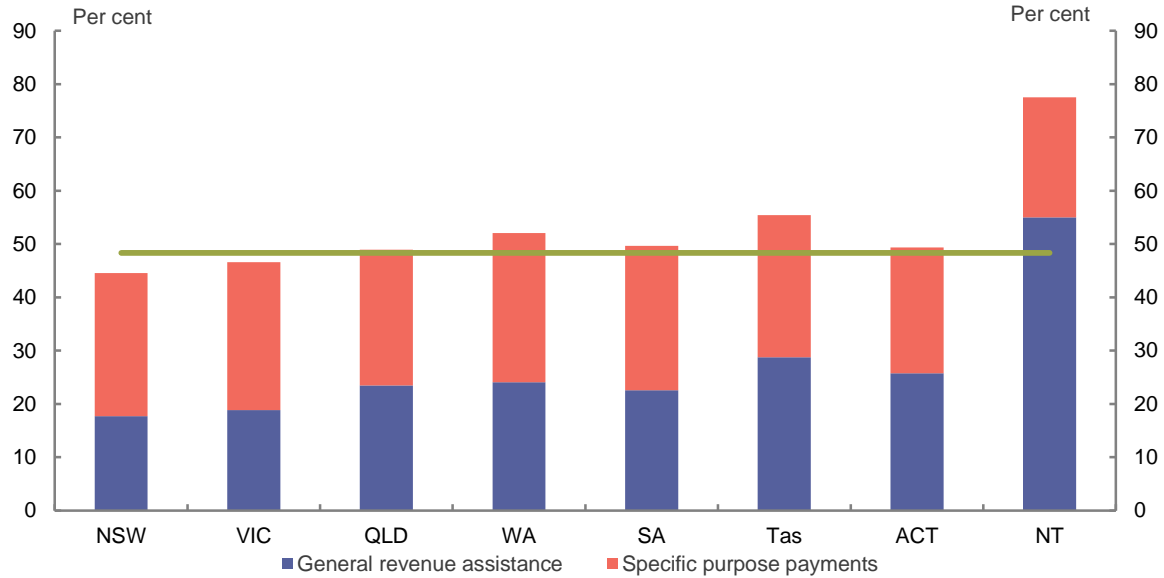


Source: Parliamentary Budget Office, 'Trends in Australian Government receipts: 1982-83 to 2012-13', 2014, p. 40.

Further background on vertical fiscal imbalance over time

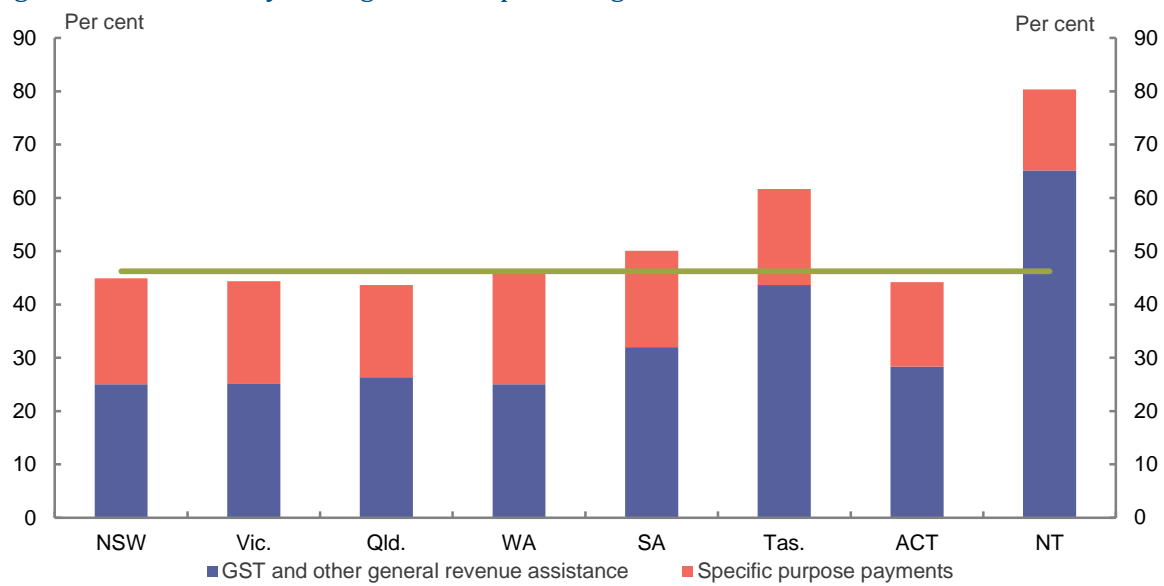
The following charts show the level of vertical fiscal imbalance by State and Territory over three points in time over the last 20 years: 1993-94, 2003-04 and 2013-14. They provide further information about VFI throughout the Australian Federation shown earlier in Figure 3.

Figure 6: VFI – State-by-State grants as a percentage of total State revenue. 1993-94



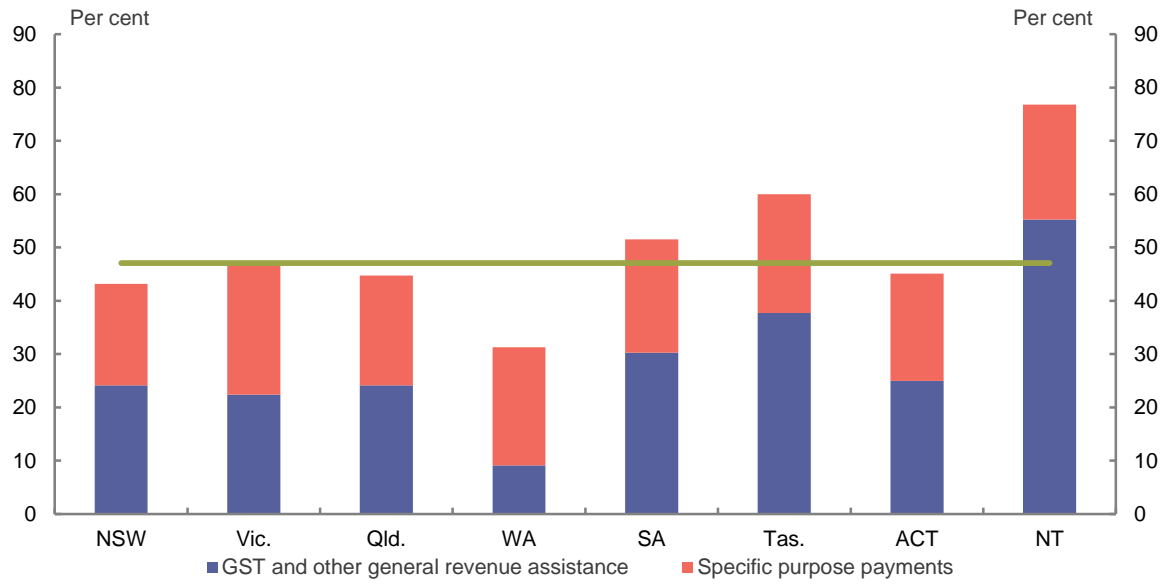
Source: ABS Cat. No. 5512.0

Figure 7: VFI – State-by-State grants as a percentage of total State revenue, 2003-04



Source: ABS Cat. No. 5512.0 and Commonwealth Final Budget Outcome 2003-04

Figure 8: VFI – State-by-State grants as a percentage of total State revenue, 2013-14



Source: State Budgets and Commonwealth Budget 2014-15

APPENDIX C: EXAMPLES OF COOPERATIVE SCHEMES

Increasingly, important national arrangements in Australia are supported by cooperative frameworks involving Commonwealth, State and Territory governments. Generally the purpose of a cooperative scheme will be to achieve national consistency in administrative or regulatory arrangements. In some cases a cooperative scheme will be under consideration because the Commonwealth is unable to cover the relevant field relying solely on existing constitutional powers. In other cases it may be seen as desirable for the Commonwealth to be responsible for aspects of a scheme but for States and Territories to be responsible for others (such as enforcement). The alternative to cooperative arrangements may be an unnecessarily complex, inefficient and uneven collection of Commonwealth, State and Territory laws. However, there are examples where the States and Territories have cooperated to implement national arrangements based in State and Territory legislation, for example, e-conveyancing and rail safety.

The mechanism established expressly by section 51(xxxvii) of the Constitution is often the best starting point for consideration in circumstances where cooperation is necessary to support a national law. Very broadly, section 51(xxxvii) allows the Commonwealth to make laws with respect to 'matters referred' by the States that are otherwise outside the scope of Commonwealth legislative power. State referrals are an effective means of ensuring national uniform and seamless administration and regulation.

An important point in favour of the section 51 (xxxvii) mechanism is its simplicity. This form of federal cooperation gives a single Commonwealth law extending to all participating jurisdictions which simply 'plugs in' to the broader federal system. For example, federal criminal and evidentiary laws of general application usually apply as they would to any other Commonwealth law. State, Territory and federal courts can be vested with jurisdiction in matters arising under the Commonwealth law. Ministerial responsibility is clear. Intergovernmental agreements underpin the legislative arrangements and establish a specific process for future amendment of the Commonwealth law that gives all participating jurisdictions a seat at the table.

Schemes to achieve reforms of national significance involve many practical as well as legal elements. Some reform proposals may be directed to improving administrative arrangements between governments. Others, probably most, involve legislative measures. These are generally directed at ensuring greater national consistency in areas of importance to the Australian community and economy.

There are real challenges in achieving uniformity, or greater uniformity, of laws of national importance. Harmonisation of existing arrangements, in particular, does not generally come easily. New cooperative mechanisms must be legally effective but must also satisfy the various policy objectives of all participating jurisdictions. This may involve some policy compromise at the margins in the interests of achieving the central shared policy objective. In other cases,

technical considerations (what is required to ensure a robust legal scheme) may influence the form of the law.

Broadly, three kinds of cooperative schemes have been established. These may be called mirror schemes (where one jurisdiction enacts a law that is enacted in the same or similar terms by other jurisdictions), applied law schemes (where one jurisdiction enacts a law on a topic which is then 'applied' by each of the other jurisdictions participating in the scheme as a law of that jurisdiction) and State referrals schemes (which involve subject, text or hybrid 'references' under section 51(xxxvii) of the Constitution). The choice of legislative framework is important. Greater technical complexity leads to higher risk of problems, in terms of both implementation and administration. The technical differences between the three approaches are significant.

Various States have referred powers over the years in areas such as:

- War time powers over railways (1915)
- Air Navigation (1920–21)
- War time powers (1942–43)
- Air transport (1950–52)
- Meat inspection (1983)
- Family law (1986–90)
- Mutual recognition (1992–93)
- Industrial relations (1996)
- Corporations (2001)
- Terrorism (2002–03)
- De facto relationships (2003–04)
- Murray Darling River Basin (2007–08)
- Fair Work (2009)
- Personal Property Securities (2009)
- Consumer Credit (2009–10)
- Regulatory reform in vocational education and training (2011)
- Business names (2011–12).

GLOSSARY

Council of Australian Governments (COAG). This is the peak intergovernmental forum in Australia and was established formally in 1992 to increase cooperation among governments in the national interest. COAG's members are the Prime Minister (who chairs the meetings), State and Territory Premiers and Chief Ministers, and the President of the Australian Local Government Association.

Gross Domestic Product. The market value of all officially recognised final goods and services produced within a country in a year, or over a given period of time.

Horizontal Fiscal Equalisation. The process whereby disparities in the ability of sub-national governments to raise revenue or deliver services, often due to factors beyond their control, are equalised. This may occur through the central government in a federation making payments to the sub-national governments to equalise their abilities to provide services at a similar standard to their citizens.

Intergovernmental Agreement on Federal Financial Relations (IGA FFR). Signed in 2008, the IGA FFR establishes the overarching framework for the Commonwealth's financial relations with the States and Territories. It is intended to establish a foundation for the Commonwealth and the States and Territories to collaborate on policy development and service delivery, and facilitate the implementation of economic and social reforms in areas of national importance.

Vertical Fiscal Imbalance. Refers to a characteristic of federations internationally where there is a mismatch between the expenditure responsibilities of sub-national governments relative to their revenue-raising capacities. As a result, sub-national governments are reliant on transfers from the central government to finance their activities, as the central government's revenue sources exceed its own expenditure responsibilities.

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