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Australian Federalism Reforms and Global Integration

by

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Abstract

This paper examines how well suited Australian fiscal federalism is to handling economic shocks in a more globally integrated world, how facilitative it is of economic reforms, and how adaptable the fiscal federalism system itself is to change.

The paper first sets out the institutional features of Australian federalism, briefly outlining the nation’s political and economic structure. While there has been virtually no change in Australian federalism via constitutional amendment, High Court constitutional interpretations and certain key events are shown to have markedly shifted fiscal control of the federation towards the federal government. The federal government has acquired almost exclusive access to the key tax bases, resulting in a particularly high level of vertical fiscal imbalance. In the consequent disbursement of grants to sub-national governments, Australia employs the most detailed fiscal equalization system of any federation.

The next sections of the study discuss three major periods of “new federalism” reforms that were attempted, with varying degrees of success, over recent decades: regionalism, fiscal decentralization and cooperative federalism. The first two reform periods, neither of which led to successfully implemented reforms, are discussed briefly and their implications for later reforms foreshadowed. Concentration is on the last reform period that saw an upsurge in cooperative federalism that brought with it a raft of reforms aimed at increasing Australia’s competitiveness.

The macroeconomic environment in which the cooperative federalism reforms came about is delineated. A rapid deterioration in the nation’s current account deficit is seen as a catalyst for reform. It is argued that there was a coincidence in motivation for reform of both the federal and state governments. The former wished to remove structural weakness in the economy that the external crisis had exposed. The latter wished to improve the efficiency of their (state-owned) business enterprises in order to overcome a financial crisis brought about in part by imprudent financial undertakings in an environment in which globalization provided easier access to world capital markets. A further inducement towards cooperative reforms to state governments was a prospect of a revitalization of fiscal decentralization reforms. The states hoped such reforms might, inter alia, alleviate them from the squeeze in their grant income that accompanied the federal government’s fiscal contraction aimed at the foreign debt problem.

The two major economic reforms to arise from increased cooperative federalism - mutual recognition and national competition policy - are then discussed. The former was designed to remove state regulatory barriers to the flow of goods, services and labor between states. The latter involved a widespread program of reforms to be carried out by the federal and state governments. These included competitive reforms to state-owned enterprises (which provide the

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bulk of Australia’s infrastructure services), reviews of anti-competitive legislation and an extension of competitive conduct legislation to previously-exempt areas, particularly the professions.

The reasons for the success of these reforms, and the failure of others on the federalism reform agenda, are examined in the context of: the theory of regulation; the substantial existing institutional framework for cooperative federalism upon which the new federalism reforms were built; the institutional framework for the provision of independent bureaucratic advice; the alignment of various political forces; and the motivations of the various participants in the cooperative reform negotiations.

The paper then explores the resilience of Australia’s economy and its federal arrangements in the context of a more globally integrated world. The advantages and disadvantages of the continued high level of vertical imbalance for Australia are outlined. It is argued that, while cooperative federalism has increased the federal government’s fiscal dominance, it has also brought a form of quasi competition between state governments. Various performance-based targets for governments have been introduced and certain federal government grants are dependent on state governments achieving various competition policy reform targets. Of particular importance have been reforms to Australia’s Loan Council rules for imposing budget constraints on governments. These have evolved from rules-based to market-based. It is argued that this has led to more efficient government borrowing and more enforceable budget constraints as transparency rules have led to genuine financial-management competition in the political market.

The effects of globalization on regional disparities are considered. Australia’s system of horizontal fiscal equalization is shown to have negative efficiency effects, but positive impacts on the unity of the federation. However, the system only plays a limited role in ameliorating interregional disparities and there has been a regional backlash against economic reforms. A challenge facing Australia is to prevent this causing “reform fatigue”.

The study concludes by arguing that the new cooperative federalism reforms have been largely successful. Australian federalism appears to manifest many of the advantages associated with decentralization while being conducive to reforms in the national interest. The competition reforms introduced by the state and federal governments in the 1990s have been given much of the credit for Australia experiencing accelerating productivity growth in the past decade. However, further federalism-related reforms are likely to be required if Australia is to continue to respond well to the pressures of globalization.
1. Introduction

The Australian federation as it has evolved over the century since it came into existence has a number of distinguishing characteristics. A high degree of separation of taxes, with the federal government having control of the major tax bases, has led to a very high level of vertical fiscal imbalance. Borrowing by all levels of government is subject to approval of the Loan Council, which is dominated by the federal government. Much of the dynamics of centre-state relations occurs against the backdrop of the fiscal dominance by the federal government.

Australia has undergone a wide range of economic reforms over the past two decades aimed at improving the efficiency of both the private and public sectors. Some of these reforms relate to changes in federal institutions and arrangements. There have been changes to the rules under which national and sub-national governments borrow, a new tax-sharing arrangement, and reviews of intergovernmental administrative bodies. Most importantly, however, has been a significant increase in the past decade of collaborative federalism which has facilitated major reforms to Australia's internal markets.

While ostensible attempts by the states to achieve a greater degree of fiscal independence that would return real autonomy over their expenditure assignment have been largely unsuccessful over past decades, the issue has played a role in the dynamics of achieving economic reform. The prospect of federal financial reforms operated as a "carrot" to the states to participate in federal/state collaborative economic reforms. As we shall see, a number of factors coincided to facilitate the collaboration on these economic reforms. What the states settled for fiscally was the receipt of all revenue from the federal government's new goods and services tax, which to them was perhaps a more desirable outcome than an expansion of their own taxing powers.

Over the past decade the Australian federal system has delivered substantial reform of the nation's internal markets which has allowed Australia to take advantage of greater global integration. While most OECD countries experienced a slowing of growth in GDP per person in the 1990s compared with the previous decade, Australia's experience was the reverse of this. The vast bulk of the acceleration in the Australian per capita growth rate in the past decade resulted from an improved productivity growth (Parham, et al, 2000). The driving factors for Australia starting to catch-up with other countries' productivity would appear to be the overcoming of structural weakness in the economy as reforms that improved domestic competition followed on from a lowering of import barriers.

The reform process has not met the universal approval of the Australian population or its media. The term "economic rationalism" has entered popular parlance in Australia in a pejorative way (see Coleman and Hagger, 2001). While such opposition in general does not seem to have markedly slowed the pace of reform, it has caused a substantial backlash in more rural electorates. Rural and regional Australia has not fared as well overall as Australia's capital cities in the benefits of globalisation and reforms. Economic reforms aimed at lowering cross-subsidisation of communication services and the like have resulted in considerable political pressure for putting a moratorium on reforms that hurt what is colloquially known as "the bush". Notions of
common citizenship rights do seem to be widely held throughout the Australian community and such concepts underlie the country's horizontal fiscal equalisation system. However, there has been constant debate between the more populous and smaller states about the benefits of what is the most detailed fiscal equalisation system of any federation. Horizontal fiscal equalisation operates mainly at the state level, and as we shall see the regional divide between winners and losers in the growth stakes pertains to a much more geographically disaggregated level.

Before analysing the reforms of the 1990s and on-going reforms, we look at some of the major political and economic features that make up the landscape of Australian fiscal federalism.

2. Australian Political Structure

2.1 The Federation

Australia comprises six states and two territories (see Figure 1 for map showing state/territory boundaries). The states are the original colonies which formed the federation in 1901. While the territories post-date federation, they have for some years been self-governing and are now treated for all intents and purposes like states. Unless otherwise noted, the term "states" will be used to cover both states and territories.

The Constitution, discussed in the next section, has remained relatively unchanged since it was adopted. Some forty-four proposed changes put to referenda have only resulted in eight amendments, and those adopted were of a largely uncontroversial kind. However, there has been a real change in the actual balance of powers between the federal, or as it is generally known, the Commonwealth Government, and the states. These changes have come about in two interpretations of the Constitution by the High Court of Australia (the country’s highest court). While the High Court at certain times has restricted the Commonwealth, it has over recent decades moved towards a broader interpretation of the Commonwealth's powers. It has been through this and other historical events that the Commonwealth Government has over time come to have substantial fiscal dominance over the states. This is now a distinguishing feature of Australian fiscal federalism, and although state governments still exercise their constitutional autonomy in many areas, their real authority has been significantly eroded.

2.2 The Constitution

The Constitution gives a small number of powers exclusively to the Commonwealth, notably the minting of money and, of particular relevance, the imposition of customs and excise duties. The Commonwealth also shares many powers with the states, particularly in areas of interstate and international activities. The main areas of federal powers of this type are: defence, foreign affairs, taxation, trade, communication, banking, insurance, social welfare, quarantine, and industrial disputes that extend over state borders. While these powers are nominally held concurrently

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1 The Commonwealth also administers a number of small offshore territories.
with the states, most of these areas have been vacated by the states, and where a state law is inconsistent with Commonwealth law, the Constitution determines that the latter prevails. The states have sole (residual) powers in general over law and order, education, health, social and community services, natural resources, rail and road transport, urban and industrial development, public utilities and ports. However, the Constitution in allowing the Commonwealth Parliament to "grant financial assistance to any State on such terms and conditions as the Parliament thinks fit" gives the federal government the capacity to influence state policy and administration in these areas.

Other sections of the Constitution relevant to this study:

- give the Commonwealth government exclusive power over customs and excise (section 90), and
- prescribe that all trade within Australia should be absolutely free (s.92).

There are approximately 650 local government units in Australia. This third tier of government is not formally recognised by the Australian Constitution and was established by state government legislation. State governments delegate to local governments such functions as local public works, waste disposal, town planning, recreation, local transport, and certain health and welfare services.

2.3 Mechanisms for Revising Centre-State Relations

Revisions of centre-state relationships are constrained in Australia. The advent of constitutional changes that might do so is unlikely. However the broad parameters of intergovernmental relations have been affected by High Court decisions on the interpretation of particular sections of the Constitution. For instance, the Court’s ruling that the Commonwealth could override state governments through its external affairs powers when the Commonwealth had an international agreement on a matter has extended the Commonwealth’s role into areas that had been previously seen as being exclusively within the province of the states. Also a series of High Court decisions have severely narrowed the tax base of state governments (see section 3.2 on vertical fiscal imbalance).

Over time the Commonwealth has also been able to strengthen its position in many areas, limiting the real autonomy of the states, by exercising its rights to make grants conditional, and by its domination of the body which controls government borrowing (see section 3.5).

Important changes to Commonwealth-state relations have also come through changes to the various bodies through which the processes of intergovernmental relations operate. Australia has a long tradition of establishing intergovernmental bodies through which the executive arms of the various governments can negotiate, deliberate, exchange information and jointly administer programs. In the early years of federation Premiers’ Conferences occurred only periodically and covered a wide

\[\text{footnote 2} \quad \text{The Australian Constitution, Section 96.}\]
\[\text{footnote 3} \quad \text{In 1983 the High Court ruled in favour of Commonwealth legislation that prevented the Tasmanian Government constructing a hydro-electricity dam largely on the basis of Australia’s international environmental obligations.}\]
range of topics. Over time they developed into an annual meeting that mainly involved the Commonwealth announcing the size of its various grants to the states.

However, additional Premiers’ Conferences were still held from time to time to discuss various issues. As we shall see, in the 1990s such Special Premiers’ Conferences, and subsequent meetings of the Council of Australian Governments (COAG) became an important component in the growth of a more collaborative federalism in Australia.

**Intergovernmental Interactions**

*The Institutions of Intergovernmental Relations*

Key institutional bodies are:

- Council of Australian Governments - meeting of the Prime Minister, Premiers (states) and Chief Ministers (territories) - has now superseded Special Premiers’ Conferences
- Treasurers' Conference - discusses grant allocations to the states (until very recently this was done at Premiers’ Conferences)
- Loan Council approves government borrowings - comprises the Prime Minister, the Premiers, or their nominees
- (Special-purpose) Ministerial Councils - ministers at Commonwealth and state level of a particular portfolio.

There are also supporting committees of officials, working parties, and joint boards and commissions.

**The Bureaucracies**

The Commonwealth and state governments each have their separate bureaucracies, which operate as completely separate entities. These bureaucracies primarily interact through the various bureaucratic committees mentioned above. In addition there are of course innumerable informal relations between officials from the various governments.

**State-State Interactions**

Prior to many of the meetings of ministers or officials outlined above, the state members of the particular bodies meet, without the Commonwealth members, to discuss the agenda issues, and presumably tactics.

There are as well interjurisdictional agencies which administer joint projects that might involve substantial externalities. A prime example is the Murray-Darling Basin Ministerial Council which has members from each of the states through which this river system flows and which deals with questions of water allocations and quality (particularly the mitigation of salinity).

**Political imbalance**

The smaller states are over represented in the Senate. Each of the original states has 12 member Senate electorates with senators being elected on the basis of proportional representation. The territories have two senators each. There is no state imbalance in the House of Representatives, where the government of the day is determined. The electorate consists of 150 single-member seats with representatives chosen by preferential voting. The two most populous states have just under 60 per cent of the population and seats.

Voting in the Senate virtually never occurs on state lines, although state issues undoubtedly play an important role in internal party policy formation. All major parties are federally structured, with state administrations being responsible in the main for senate nominations.
3. **Economic Structure**

3.1 **Background**

The basic features of the economies of Australia's eight states and territories are shown in Table 1. While there are differences across the states, the variations in economic structure and standards of living between the states are not particularly large. Over the past decade the export-oriented states of Queensland, Western Australia and the Northern Territory and have grown slightly faster than the two most populous states, New South Wales and Victoria (which together make up around 60 per cent of the economy). The two smallest of the states (not including the territories), South Australia and Tasmania, have grown at much lower rates than the rest of the economy, and have somewhat more elevated unemployment rates.

A graph of Australia's GDP growth rate over the past two decades is shown in Figure 2. As can be seen the nation enjoyed a healthy growth rate of around 4 per cent in a typical year of the 1990s. This partly reflects the effects of productivity-increasing economic reforms put in place during the decade. It was the experience of the 1980s that formed a catalyst for those reforms. One of the most important of these experiences was the worsening current account deficit which, following a marked deterioration in the three years to 1985/86, led to Treasurer Paul Keating's warning that corrective action needed to be taken to avoid an external debt crisis. Keating identified the cause of the deficit as the fall in prices for Australian export commodities, but stated that overcoming this required fundamental structural adjustment. The primary macroeconomic instrument used by the government to tackle the external deficit problem was increases in interest rates, in order to dampen strong growth in GDP and consequentially reduce imports. A tight fiscal policy was also introduced, a main component of which was severe cuts in grants to the states.

Whether Australia's current account deficit presented a problem that warranted the drastic interest rate policy imposed by the government is debatable, particularly as the majority of Australia's external debt was private. Pitchford (1989 and 1990) and Sjaastad (1989) present persuasive arguments that no satisfactory case had been made that the Australian current account deficit was excessive. Whether there was any sort of external account crisis and the degree of efficacy of the government's monetary policy in overcoming it is debatable, but the "crisis" did appear to galvanise governments and business towards the idea that internal market reforms (or microeconomic reforms as they are known in Australia) were needed as a long term solution. This matter is examined further in section 5.1.

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4 While the growth rate fell off at the turn of the century this probably represents a distortion in the timing of investment activity associated with the introduction of the goods and services tax. Growth recovered in the first half of 2001-02 and is projected to exceed 3 per cent for the next three years.

5 In a popular radio interview Keating put the case dramatically, saying, "if this government cannot get the adjustment … then Australia is basically done for. We will just end up being a third-rate economy … a banana republic." (quoted in Bell and Head, 1994, p. 13). This rhetoric was successful at awakening the Australian public to the problem and preparing the ground for the government's policy reaction, although probably at some political cost.
3.2 Vertical Fiscal Imbalance

Australia exhibits the highest degree of vertical fiscal imbalance (VFI) of the mature federations. This high degree of VFI is due basically to sub-national governments being shut out from the two major sources of government revenue in modern economies, namely (personal and company) income tax and all forms of sales taxes. The states' exclusion from the latter taxes results from the High Court's interpretation of (federally-exclusive) excise tax to include any taxes that might directly affect the production or sale of goods (Walsh, 1993). The Commonwealth's total control over income taxes dates back to 1942, when the Uniform Income Tax Act was introduced as a temporary wartime measure. In section 7 below we discuss why the states, despite having the legal right to reimpose state income taxes, have never found themselves able to do so successfully.

Australia's level of VFI has been very high for over half a century. There was some lowering of the level in the mid 1990s, but Grewal (1995) argues that this has come at the cost of the states making a greater tax effort in the area of inefficient taxes. In 1997 the High Court banned the states' business franchise fees on tobacco, alcohol and petroleum products, ruling that they were effectively excise taxes. This adverse decision eliminated over 15 per cent of the states' own-source revenue. The Commonwealth instigated a rescue package, increasing its own tax on the affected products (the Safety Net Surcharge) and handing the revenue back to the states. There were, however, various complications due to significant interstate differences in franchise tax rates, and it was clearly a stop-gap measure (James, 1997). In July 2000 a Goods and Services Tax (GST) was introduced in Australia. Under an intergovernmental agreement all GST revenue collected by the Commonwealth government would be provided to the states who would no longer receive the general purpose revenue assistance they previously received from the Commonwealth. In terms of the federal government's tax mix, the GST mainly replaced the wholesale sales tax and a portion of personal income taxes. However, under the agreement the states acquiesced to the discontinuance of the Safety Net Surcharge and to a requirement that they cease to impose several of their existing (more inefficient) taxes.

Revenue sharing of taxes collected by the national government is often considered to be a way of reducing the level of VFI (Groenewegen, 1990). However, it is not clear that the GST arrangements have lowered Australian VFI in any meaningful sense.

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6 Mathews and Grewal (1997) standardise conventional measures of VFI to remove the effects of discretionary policy changes. The standardised measure shows a much-reduced improvement in the 1990s and a higher imbalance than in the early 1970s.
7 New South Wales sought to defend a challenge to the tobacco franchise fee by re-opening the definition of excise duty. Painter (1998) argues the State did so in an attempt to establish a more certain revenue base. For a discussion of the High Court's rulings on the definition of excise and the background to the Ha & Lim case, see Saunders (1997).
8 Prior to this Australia, unlike most developed countries, did not impose any form of value-added tax.
9 Strictly speaking the states gave up what was termed Financial Assistance Grants, which after some adjustments, reconcile with general-purpose grants, as the term is usually defined in the Australian literature.
10 The states were required to cease accommodation taxes, financial institutions duty and stamp duty on marketable securities, and to adjust their gambling taxes to take into account the GST. It was also agreed to review in 2005 whether a range of other state government stamp duties should be retained and to cease state debit taxes at that date.
While the Commonwealth has argued recently that the GST should be regarded as a state tax that is merely collected by the Commonwealth, the Australian Bureau of Statistics (ABS) treats the GST as a Commonwealth tax\textsuperscript{11}. The GST revenue sharing arrangements do not have constitutional force, unlike the case of Germany's revenue sharing arrangements. It is worth noting in this respect that from 1976 to 1985, a fixed share of Australian income taxes (or of all federal taxes after 1981) was earmarked as the states' share, but this was abandoned in 1985-86 as a fiscal contraction saw the Commonwealth sharply cut its grants to the states. Sharman (2001) speculates that this might also happen eventually in the case of the assignment of revenue from the GST to the states. Using the ABS definition, in 2000-2001 the Commonwealth still collected around 76 per cent of total government revenues even though its own-purpose outlays represent around 52 per cent of general government outlays. On the other hand, state and local governments raised only 23 per cent of total revenues. (See Tables 2 and 3 for government finance statistics that show the basic features of expenditure and revenue assignments.) These figures show little difference from historical measures of VFI over an extended period.

3.4 Grants

Table 4 shows Commonwealth payments to state and local governments by major grant category for the years 1997-98 (the final year that the states were permitted to collect business franchise taxes on their own behalf) and 2000-01 (the first year of operation of the GST). It will be noticed that there was a substantial increase in the size of Commonwealth payments, largely explained by the Commonwealth replacing revenue from the now discontinued state franchise (and certain other) taxes with GST revenue.

While the Commonwealth agreed to distribute to the states all GST revenue from the year the tax was introduced (2000-01), for each state this would have amounted in that year to less than the revenue forgone from the previous grants scheme (including the abolished state government taxes and certain expenditures agreed to by the state government).\textsuperscript{12} The Commonwealth guaranteed under the intergovernmental agreement that no state's budgetary position would suffer as a result of the introduction of the GST. In order to meet this obligation the Commonwealth is paying state governments additional grants, or Budget Balancing Assistance (BBA), to cover the difference between GST revenue and a guaranteed minimum amount, computed as the revenue forgone.

In 2000-01, GST revenue, the BBA and specific-purpose payments (SPP) made up about 45 per cent of total state general government revenue. GST and BBA revenue are distributed among the states on the basis of relativities recommended by the Commonwealth Grants Commission, in order to equalise fiscal capacities, in the same manner as was the case for the general revenue grants that the GST replaced. Australia's system of horizontal equalisation and reform possibilities are discussed in Section 10.

\textsuperscript{11} It is worth noting that following the High Court's 1997 decision the ABS continued to treat business franchise taxes as state taxes, since in that case the Commonwealth was undoubtedly collecting these taxes on the states' behalf.

\textsuperscript{12} The state governments agreed to fund a First Home Owners Scheme and to compensate the Commonwealth for the cost of administering the GST.
SPPs (or tied grants) for both recurrent and capital purposes amount to around as much as GST payments. While SPPs have a long history in Australia, it was not until the 1970s that there was a rapid growth in these types of grants. The Commonwealth promised SPPs would not be reduced as part of the GST reform process. The interstate distribution of SPPs is taken into account by the Commonwealth Grants Commission in its assessment of equalisation relativities for distributing GST revenue. The bulk of SPPs cover current and capital expenditure in education, hospitals, roads and housing. Certain SPPs merely pass through the state governments, notably to higher education and local governments. Most SPPs are not subject to any rigorous matching requirements, but most involve intricate intergovernmental arrangements. In Sections 5 and 7 we discuss how desires to reform SPP conditions have been an integral part of the collaborative federalism reform push of the 1990s.

3.5 Public Sector Borrowing

A singular feature of Australian federalism is the Loan Council which has for over seventy years engaged in the coordination of the borrowings of three tiers of government. It commenced operations on a voluntary basis in 1927 to coordinate terms and conditions of loans by Commonwealth and state governments who were competing for funds in a thin domestic capital market - the former to refinance World War I debt, the latter to finance soldier settlement and infrastructure development (James, 1992). In 1927 the Council was formalised by the Financial Agreement which was ratified by a 1928 constitutional amendment. The Council is comprised of the heads of governments of the Commonwealth and each of the states, or their nominees. The Commonwealth has two votes, plus a casting vote. While it is possible that the Commonwealth can be outvoted, its monopoly of the major revenue sources means that in practice it also dominates the Loan Council. From the time of the inflationary economic boom of the early 1950s the Commonwealth has used the Council as an instrument of macro-economic management. A number of commentators have noted that this has not only allowed the Commonwealth to influence the economy, but also to circumscribe the fiscal independence of the states (Saunders, 1990).

Gramlich (1984) notes that the more stringent the Loan Council restrictions are, the more creative the states are in devising ways of circumventing the Council. Initially this took the form of employing statutory authorities, not covered by the Financial Agreement, to undertake borrowing on behalf of general government. In 1936 a voluntary 'Gentlemen's Agreement' was negotiated to bring such authority borrowing, including those of local authorities, under Loan Council supervision. From the 1970s the states found new methods to circumvent the Council through the exploitation of unconventional financing arrangements, such as leveraged lease-back schemes (which

13 Mathews (1984) notes that the "existence of the Loan Council itself helped to blunt overseas criticism and improve the credit standing of Australian governments".
14 The states did outvote the Commonwealth in 1951, but could not raise the funds to reach the higher borrowing limit.
also involved some tax avoidance) and "security deposits" (Gramlich, 1984). In the
four years to 1983-84 the share of state and local authority borrowings approved by
the Loan Council plunged from 95 per cent to 25 per cent (James, 1992). With the
effectiveness of the Loans Council compromised, the Gentlemen's Agreement was
abandoned in 1984 in favour of a system of global limits over total borrowing, both
conventional and unconventional.

Under the new arrangements states were free to determine the terms and conditions of
their borrowing. The states had begun to set up central borrowing authorities and in
1991-92 a ceiling of 22 per cent of overseas debt in state borrowing was lifted.
Pressure to further relax controls was still present, particularly given deregulation of
the private financial sector in the mid 1980s. In particular, government business
enterprises (GBEs) were seen to be at a disadvantage to private sector firms due to
Loan Council borrowing constraints. As we shall see, governments were in the
process of placing their GBEs on a commercial basis, and this led in 1991 to GBEs
operating in competitive markets being exempted from control under the global limits.
In December 1992 new procedures were adopted which switched the focus from
global limits to the relating of borrowing allocations to governments' deficit (surplus)
adjusted for a number of other transactions which have the characteristics of
borrowings (Australian Loan Council, 1993).

A key component of what are still the current arrangements are improved reporting
requirements to provide accurate, transparent and meaningful information that
facilitate financial market scrutiny of public sector finances. Each government
nominates a Loan Council Allocation (LCA) for approval by their fellow Loan
Council members, but the LCAs are not binding in a legal sense. The Loan Council
had thus changed its philosophy "from an approach based on rigid compliance to one
based on the establishment of a credible and transparent framework for the allocation
of net borrowings" (Australian Loan Council, 1993). In essence the Financial
Agreement and the traditional functions of the Loan Council had effectively been
made redundant (Painter, 1998).

In virtually deregulating government borrowings the Loan Council stated they wished
to provide the basis for the states to assume "greater freedom and responsibility in
determining their financing requirements". However, to ensure that borrowings were
consistent with the states' fiscal and debt positions, and the nation's overall
macroeconomic strategy, the Loan Council implemented a joint Commonwealth/State
budget forecasting exercise. The Loan Council Allocations (LCA) nominated by the
states are considered in the light of the National Fiscal Outlook, which contains
nationally agreed debt targets.

The question of how to impose workable hard-budget constraints on all levels of
government is an important one to overcoming the dangers of decentralisation

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15 Attempts to circumvent the Loans Council have not been exclusively a state activity. An attempt in
1975 by senior federal government ministers to evade the Loan Council ultimately led to a
constitutional crisis and the dismissal by the Governor-General of the Whitlam government (Mathews,
1997, 63-65).

16 For this exercise it is a combined underlying general government and public trading enterprise sector
budget result which is estimated. Public financial enterprises are excluded.

17 In considering the appropriateness of LCA nominations the Council also considers such matters as
public sector risk exposure to infrastructure projects with private sector involvement.
(Seddon, 2001). The motivations for the introduction of the new borrowing arrangements, circumvention of the Loan Council rules and GBE-private sector capital market distortions, bear testimony to the difficulties of instituting hard budget constraints on sub-national governments. The new approach of decentralised discipline via market and political pressures seems to have been successful to date (Craig, 1997). Credit ratings of state governments by international agencies are given considerable media attention and voters seem to be very attuned to the dangers of fiscal mismanagement. These factors are no doubt partly an outcome of some adverse experiences of the 1980s, which we discuss below. It can be seen that the market and political pressures reinforce each other. While the arrangements do not involve no-bailout rules, the budget forecasting process and a narrow tolerance rule in departing from LCAs mean that the Commonwealth is able to bring its fiscal dominance to bear to head off any emerging state government debt problem.

Walsh (1996a, p.10) sees the current Loan Council arrangements of significance to "the management of economic policy and international competitiveness in a globalised world". He sees a role for the National Fiscal Outlook beyond that of the understanding and annual approval of public sector financing requirements. The document forms a potential basis on which the Commonwealth could pursue with the states a more formal approach to national fiscal policy. Even without formally agreed procedures for policy coordination, notes Walsh, the Outlook document serves a role in federal fiscal relationships by objectively highlighting the contribution of each government to the nation's future financing requirements.

3.6 Horizontal Fiscal Equalisation

Australia has for many years employed a system of interstate transfers aimed at removing one sort of regional disparity; namely that associated with fiscal imbalance. The Commonwealth Grants Commission (CGC) was established in 1933 to recommend special grants for states suffering disabilities arising from federation. For many years these grants involved only a few claimant states. However, in 1982/83 Commonwealth Grant procedures began to be used to distribute all general-purpose grants to the states. Grewal (1999) considers that Australia "has adopted arguably the most elaborate and comprehensive approach" to HFE of any federation. The CGC assesses state per capita shares of the revenue pool on the basis of both revenue-raising capacities and the unit costs of providing public services in each of the states.

The CGC (1999) describes the principle of fiscal equalisation it employs as that where:

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18 Australian state politicians are quick to point out the interest savings involved when there is an upgrading of the credit rating of their state.
19 Credit rating agencies would no doubt be aware that the Commonwealth Government does at times assist states that find themselves in financial difficulties. In 1990, the State Bank (of Victoria) collapsed and was rescued by the Commonwealth Bank which acquired it at the behest of the federal government. This occurred shortly before the partial privatisation of the Commonwealth Bank commenced.
20 If a government becomes aware that its borrowing is likely to be more than 3 per cent different from its LCA it must report this to the Loan Council, with an explanation which may be made public.
21 During the global limits arrangements, the Commonwealth threatened Queensland with a reduction in its general revenue grants if that state exceeded its borrowing limits (Senate Select Committee, 1993).
"State governments should receive funding from the Commonwealth such that, if each made the same effort to raise revenue from its own sources and operated at the same level of efficiency, each would have the capacity to provide services at the same standard".

While intergovernmental grants that compensate states for disabilities has been a feature of the Australian federation for much of its history, they have been the target of a continued campaign for their elimination by the two largest states (New South Wales and Victoria) over the past dozen years. These states have been long-term donor states, in the sense that they receive less than their population share of total Commonwealth funding to the states. Together with Western Australia, which is set to join the category of donor state after a long history as a claimant state, New South Wales and Victoria have set up an independent inquiry to report by 31 May 2002 "on whether the current system [of allocation] is effective in relation to:

i) efficient allocation of resources across Australia to enhance national employment and economic growth;
ii) achievement of equitable outcomes for all Australians; and
iii) simplicity and transparency."

There are substantial reasons for considering that the CGC approach is ineffective in all three areas. There is a long literature on the question of HFE. Proponents of equalisation point to the work of Buchanan (1950), Boadway and Flatters (1982) and others as providing a sound theoretical foundation for HFE. In a report to the NSW Treasury, Swan and Garvey (1995) consider the nine main arguments in support of HFE. Whatever the merit of these arguments, none of them form the basis for the methods employed by the CGC. For instance, the Grants Commission makes much of the fact that its method protects autonomy of the states by not requiring them to provide the same standard of public services as the other states; it merely provides them the capacity to do so. Buchanan's 1950 paper argues for equalisation, however, on the basis that equals in different states should be treated equally. Even if the CGC designed its formula to enable this, fiscal autonomy means that such equal treatment still may not occur.

There has been some debate in Australia about the efficiency effects of the HFE system. Petchey (1995) argues that equalisation can correct for inefficient migration motivated by interstate differences in the distribution of capital returns to residents. Dixon, Madden and Peter (1993), using different assumptions about capital, show HFE to involve inefficiencies - but they also demonstrate that these inefficiencies are necessarily relatively small. These and other authors have normally taken it as given that the formula is policy neutral as the CGC claims. However Swan and Garvey (1995) demonstrate that the formula, because it uses population rather than revenue and expenditure weightings to compute standard expenditure and revenue efforts, causes claimant states to specialise in areas of expenditure and revenue raising in which they are inefficient. However Swan and Garvey undertake no numerical calculations to examine whether the level of such inefficiency is of any consequence.

The elaborate HFE process in Australia generates a degree of waste simply through the cost of its administration. Revenue disabilities (positive or negative) are separately assessed by the CGC for 19 categories of revenue items. Computations of
expenditure disabilities are based on separate assessments for 41 expenditure categories and are computed for a range of factors, such as the physical environment, dispersion, urbanisation, diseconomies of scale and population characteristics. Assessment of each category involves detailed information from the states on policy and other factors that affect revenue and expenditure. Often the required data is not available or incomplete, and the CGC must use its judgement. Despite the acknowledged professionalism of the CGC, the complexity of the process (including adjustments to allow for interstate differences in SPP receipts) leaves it open to question. The process also involves lobbying costs as states seek to influence the outcome by attempting to convince the CGC to alter the categories to which various items are assigned.

While the CGC is only an advisory body, its recommendations are generally accepted by government. The CGC is highly respected for its independence and impartiality. The Commission is a frequent promoter of the HFE method which it employs, seeing it as delivering interstate equity while still allowing diversity of behaviour (see, for instance, Commonwealth Grants Commission, 1995, and Rye and Searle, 1997). Russel Mathews, a member of the CGC for almost twenty years, in one of his numerous articles on the subject, describes HFE as the linchpin of the Australian federation (Mathews, 1994).

CGC commissioners are appointed by the Commonwealth Minister for Finance and Administration, following consultation with the states, but with no requirement for any particular state composition of the Chairperson and three members. However, the HFE formula does result in a consistent pattern of redistribution of grant funding from the two most populous states of New South Wales and Victoria to Queensland, South Australia, Tasmania, the Australian Capital Territory, the Northern Territory and, until recently, the Western Australia.

The CGC process has for many years been seen as one that forms a unifying role in the federation. It forms a convenient way for the Commonwealth to transfer a potentially divisive issue to a body outside of the political arena, thus avoiding the risks and probable odium of deciding matters of redistribution by a simpler formula or some other method open to political lobbying. The degree to which Australia's fiscal equalisation system might be an outcome of its electoral system does not appear to have been a subject for research, or even speculation. As in the United States, all states (but not the territories) have equal representation in the Senate. While senators generally vote along party lines, and virtually never along state lines, interstate issues are likely to play a role in determining policy positions within each of the main federally-structured political parties. Senators from the claimant states do form a majority even though it is never used. Also the amount redistributed away from the donor states (which comprise around seventy per cent of the Australian population) is not large in per capita terms, but for the smaller claimant states the per capita amount received is relatively large. Significantly, in their attempt in early 2001 to have the HFE system changed, New South Wales and Victoria sought to restrict HFE payments so that they would be received only by the three states with the largest

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22 In the past the number of categories were even larger - 31 in the case of revenue and 70 in the case of expenditure (Grewal, 1999).

23 Grewal (1999) provides an example of one state's grant significantly increasing due to out-patient expenditure being switched from Community Health Services to Hospital Services.
disabilities, namely South Australia, Tasmanian and the Northern Territory, effectively trying to isolate politically Queensland and the Australian Capital Territory\textsuperscript{24}. The move has been unsuccessful so far, and whether the nature of the HFE system might be partially politically determined, remains an open question.

4. Inter-Governmental Reforms

Over the past three decades there have been three major periods of "new federalism" reforms. The first reform program was advanced by Gough Whitlam (Prime Minister 1972-75). The major elements of his approach were that the Commonwealth should be the initiator and coordinator of policy in areas of traditional state responsibility (e.g. health, education, transport and urban development), and that such programs should be funded by the Commonwealth, but administered at the sub-national level. Proposals were put forward to regionalise administration, at a new sub-state supra-local level\textsuperscript{25}. The Whitlam government's regionalism plans were never instituted, and the regional development thrust that they initiated did not survive. However, the large increase in SPPs to the states which formed the means by which the Whitlam government introduced its social-policy agenda, has continued to have a profound effect on the operations of Australia's fiscal federal system.

The second "new federalism" reforms of the Fraser government (1976-1983) were largely a reaction to the previous government's federalism policies. Fraser's Liberal government reaffirmed its allegiance to federalism, which the Australian Liberal party had always supported as promoting democracy and accountability by dividing power (Roberts, 2001)\textsuperscript{26}. The Fraser federal government instituted new financial arrangements with the states with the expressed aim of increasing state independence in terms of both expenditure and revenue. SPPs were reduced, as various Whitlam programs, particularly urban and regional development, were wound back. As noted earlier, revenue sharing was introduced by the Fraser government by designating fixed portions of personal income tax for each of the three tiers of government. The states' new tax sharing entitlement of 33.6 per cent of income tax replaced general-purpose payments\textsuperscript{27}. Enabling legislation was also passed in 1978 by the Commonwealth which gave the states power to increase or reduce the income tax rate applying to residents of their state. The Commonwealth would collect the surcharge (or administer the rebate) and adjust the state's tax entitlement as appropriate. The reasons why no state instituted a surcharge or rebate in the period until the \textit{Income Tax (Arrangements with the States) Act} was repealed in 1989 are discussed in Section 7 below. The Fraser government also set up the Advisory Council for Intergovernmental Relations (ACIR), which was funded by all levels of governments, to conduct independent research into federalism issues. The ACIR, modelled on the

\textsuperscript{24} Both Queensland and the ACT enjoy strong fiscal positions (New South Wales Treasurer, 2001, 8-14).
\textsuperscript{25} Whitlam in a 1971 speech as opposition leader appeared to advocate the replacement of three tiers of government with two (Jaensch, 1997) - the Commonwealth to deal with international/nationwide matters, and new urban/regional assemblies to deal with sub-national affairs. In government this proposal was watered down to one where new regional bodies (not a new tier of government) would plan and administer programs for their areas.
\textsuperscript{26} The Labor party, on the other hand, held centralist views, and its constitution, before Whitlam instigated a change in 1971 was avowedly opposed to federalism (Sawer, 1975).
\textsuperscript{27} This share gave states some increase in general-purpose current funds from the Commonwealth, but insufficient to offset the cuts to SPPs and capital grants. See Table 8.5 of Mathews and Grewal (1997).
US Advisory Commission on Intergovernmental Relations, carried out a research program for a decade, but never achieved its potential, being terminated in 1987.

The third "new federalism" reform period did not commence until the 1990s. By that time the Hawke Labor government had been in office seven years and had undertaken reforms in a wide range of areas, in particular the floating of the Australian dollar, the deregulation of financial markets and trade liberalisation. In a speech to the National Press Club entitled "Towards a Closer Partnership", Prime Minister Hawke highlighted problems arising from lack of coordination and regulatory conflict between the states. He cited examples of different product standards, occupational registration requirements and transport regulations, and claimed that by 1992 there would be fewer impediments to trade and movement between European Community countries than Australian states.

Hawke invited the state premiers (and some representatives of local government) to a series of Special Premiers' Conferences to undertake a major cooperative review of intergovernmental relations in Australia. The agenda was to be determined at the initial conference, but Hawke immediately identified the essential components:

- a microeconomic reform program to improve Australia's international competitiveness via such measures as deregulation of GBEs owned by all levels of governments and removing regulatory barriers to interstate flows;
- greater coordination in public service delivery to remove duplication and overlap, and to help deliver the national social justice strategy;
- a more common approach to industrial relations and environmental issues; and
- a review of Commonwealth-State government financial arrangements to examine the problem of tied grants and arrangements at the annual Premiers' Conferences that, formally at least, determine the level of intergovernmental transfers to each state.

The new federalism of Hawke differed from previous federal reform programs, as it did not involve an unequivocal unilateral action by the federal government. At the first Special Premiers' Conference in October 1990, the state premiers clearly showed their willingness to engage in the process and the conference put in place an agenda for reform, encompassing both the Hawke agenda and some other items already under intergovernmental consideration. It is commonly held, however, that the states' priorities differed from those of the Commonwealth (see Fletcher and Walsh, 1992 and Painter, 1997). The federal government's primary motivation was to enable it to

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28 The third reform period started with the Hawke Labor government (1983-1991) and continued through the Keating Labor government (1991-96) and into the Howard Liberal government (1996 to present).

29 See Painter (1997, p.3) for an apt quote of Hawke's speech on the legacy left to Australian railways from its colonial engineers. Cargo transported by rail across the country faced numerous rail gauges, engineering standards and workplace safety systems.

30 The term "microeconomic reform" is a very commonly used term in Australia "to refer to changes in government policy directed at improving the efficiency of use and allocation of Australia's resources" (Productivity Commission, 1998, p.1).

31 Additional items included uniform building regulations and national food standards (Painter, 1997).
advance its microeconomic reform program in a drive for "national efficiency and international competitiveness". However, much of the reform program involved areas within the preserve of the states, and therefore their cooperation was essential. The states also had begun to develop a microeconomic reform program, particularly in the area of GBEs, and linking their program with that of the Commonwealth had the advantage of achieving these reforms while possibly avoiding some of the political cost. However, it was the hope of changing fiscal federalism arrangements to acquire greater control over revenue sources and over expenditure in their constitutionally assigned areas such as education, health, housing and transport, where the states saw the main advantages of a review of intergovernmental relations. In these areas their objectives largely ran counter to those of the Commonwealth.

The extensive growth in collaborative federalism that the intergovernmental review initiated marked a fundamental reshaping of Australia's federal system (Painter, 1997). While centre-state friction is still prevalent, intergovernmental committees at ministerial and official level have for a decade worked towards policy and administrative solutions aimed at national approaches, removing interstate regulatory incompatibilities and interstate barriers. The process has delivered some important reforms to the Australian economy, in particular national competition policy (NCP) and mutual recognition between states of standards and qualifications. While mutual recognition was introduced in 1993 and the NCP reform program, which started in 1995, is still continuing, progress in other areas has been more limited. In the following sections we consider the two major agenda items that were at the core of the intergovernmental reform push of the 1990s: microeconomic reform and vertical fiscal imbalance. We consider what factors pushed these reforms to the fore and how the reforms and the intergovernmental processes were integral to each other. We then examine the nature of the reforms, the economic distortions that the reforms were intended to overcome and the efficacy of the reforms in meeting the challenges of globalisation. Consideration is also given as to why the microeconomic reform program has advanced successfully, while the VFI reforms have progressed far more slowly, with the states making little headway in achieving the changes that they were seeking to SPP arrangements and VFI reforms seemingly abandoned.

5. Collaborative Federalism

5.1 "Crises" and Reform

The external balance "crisis" helped set the climate of ideas that convinced the federal government that there were structural deficiencies in the Australian economy (Gerritsen, 1992). The Labor government had shown from the time of taking office in 1983 a strong pragmatic tendency that made it amenable to economic advice and it introduced a number of major deregulatory reforms early in its first term. A strong campaign for trade liberalisation by the Industries Assistance Commission (IAC) and other advisers to government began to take effect. In a May 1988 Economic Statement, major phased tariff cuts were announced. A continuation of this program in a 1991 Industry Policy Statement meant that most nominal tariff rates were to be

32 Nominal tariff rates above 15 per cent would be reduced to that figure, while those between 15 and 10 per cent would be reduced to the lower figure. However, the two most inefficient industries, Motor vehicles and Textiles, clothing and footwear, were exempted, and have faced much slower reductions in the levels of assistance they receive.
phased down to 5 per cent by 1996. It is difficult to ascertain the degree to which a macroeconomic crisis spurred a reform climate, but there were clear long-run motivations in the government's trade policy. Thus Corden (1997) hypothesises that the Labor government was pursuing tariff reduction policies because they had come to believe that this "would raise national efficiency or productivity, and thus also make both higher real wages and improved welfare provision possible."

Having put in place reforms to make Australia more open to external competition (by financial market deregulation, floating the dollar and lowering import barriers), the federal government began to turn its attention to internal barriers to trade. In 1989 the IAC was renamed the Industries Commission and its brief was extended to encompass the broad scope of microeconomic reform. We leave aside the nature of the wide range of reforms that now came under consideration by the federal government. However, many of these reforms became central to the collaborative federalism process, and we discuss these below.

A number of forces were also acting in the 1980s to increase the state governments' proclivity towards microeconomic reform by the end of the decade. One of the major forces was the Commonwealth government's external debt reduction policy. During the latter half of the 1980s the federal government's fiscal contraction fell heavily on grants to the states (Mathews, 1997, pp 537-8). This was compounded by the negative impact of the 1991/92 recession on the states' narrow tax base. The revenue decreases intensified the states' concern with VFI and made them amenable to any reforms that might include changes to this area within the package.

However, the Australian state governments were also culpable for the financial difficulties that they fell into in the second half of the 1980s, and this too proved to be a stimulus for reform. The problems of several state governments arose from state development corporations (such as the Victorian Development Corporation) providing venture capital to risky undertakings that failed, and state banks (in Victoria and South Australia) collapsing in the wake of injudicious lending practices. In Victoria, the state government assured depositors of the safety of a financially troubled building society (Pyramid), despite the government seeming to have information to the contrary (Norman, 1995, p.39). Having effectively provided a guarantee, the Victorian government had to sustain substantial costs in paying out depositors. Similar imprudent actions in Victoria and other states compounded the deficit problems of those states.

The first state to begin to make reforms to cope with the problem was New South Wales with a range of financial management measures and expenditure restraint. It began an extensive program of reforming its GBEs, which were severely overstaffed and heavily subsidised. Other states followed suit, reforming their GBEs, with the main purpose of repairing their financial position. During the early 1990s all state

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33 Prior to this the IAC inquired primarily into the effects of protection against imports.
34 Most states were for some time shielded from the federal cuts by increases in own-source revenues from those taxes which had booming asset prices and property values in their base. However, this position was rapidly reversed with the 1991/92 recession.
35 Not all states experienced a financial crisis. Queensland, a traditionally low taxing and spending state, and the Australian Capital territory were exceptions.
36 Painter (1995) notes that it was only by taking large dividends from its GBEs that the NSW government managed to balance its budget.
governments that had experienced financial problems began to take action to reduce their burgeoning debt. The Hawke initiative to reform intergovernmental relations was seen by the states as an opportunity to improving fiscal arrangements with the Commonwealth, which they saw as a major cause of their financial problems (Painter, 1998).

5.2 The Collaborative Federalism Reform Process

The broad reform areas that were agreed on at the October 1990 Special Premiers' Conference formed the basis of the agenda for a series of meetings, both at heads of government level and for working parties of officials. Early action was exhibited with the establishment of national commissions for both road and rail transport, and a national electricity grid management committee. An agreement on road vehicle regulation, designed to institute uniform heavy-vehicle regulations and charging, was accompanied by the Commonwealth agreeing that $350 million in road grants to the states should no longer be tied. By July 1991 there was also an in principle agreement that there should be mutual recognition by the states of each others' regulations on goods and occupations.

The collaborative federalism process, however, was almost derailed later in 1991, when it became a central issue in a Labor party leadership battle. Paul Keating, who was soon to become Prime Minister, criticised the collaborative process, saying that it was insufficiently open to public scrutiny and could give the states certain powers that it was vital for the national government to retain. Of particular concern was a new proposal for a state income tax that had been put forward by the state premiers. The federal government rejected the proposal and the state premiers withdrew from the next scheduled Special Premiers' Conference.

However, the premiers held their own meeting and agreed on a scheme for introducing mutual recognition that involved referring power to the Commonwealth to enact uniform legislation. Among other matters that was resolved at this meeting was an in principle agreement for a national competition policy.

While the new Prime Minister Keating took a more centralist position, the need for state government involvement in on-going microeconomic reform, and the momentum that collaborative federalism had built up, saw the process continue. In 1992 it was agreed that a Council of Australian Governments (COAG) would be established, following a proposal by the state premiers for a permanent forum. COAG, which replaced the Special Premiers' Conferences, would meet at least once a year in addition to the regular Premiers' Conference on financial grants. The federal government also agreed to a general-revenue funding formula for the states, which provided a guaranteed growth factor.

However, a considerable amount of federal-state conflict also continued. A new Liberal government in Victoria was rapidly pursuing its own reform policy, including proposed "anti-union" industrial relations reforms. The federal Labor government, with ties to the union movement, opposed these reforms and used its external affairs power to override the Victorian law. In this atmosphere, the states refused to take part in a review of competition policy. The Commonwealth went ahead and established an independent review of national competition policy to be conducted by Professor Fred
Hilmer. However, constitutional uncertainties as to how far the federal government could achieve its objectives without a corresponding reform program by the states meant that a cooperative approach was required; and this approach was recommended by the report when it was released in August 1993 (Hilmer, et al, 1993).

Microeconomic reform was very much on the agenda in the second half of 1993 and an intergovernmental working group was established to determine new initiatives. All governments publicly affirmed the need for microeconomic reform. However, some states had reservations surrounding the creation of national markets. Painter (1998, p.48) argues that there has been a long history of the smaller states attempting to protect their markets from interstate imports. The states also saw the intergovernmental considerations on competition policy as an opportunity to revive their claims for financial reforms. The states put the case that proceeding with the new microeconomic reform initiatives as advanced by the Commonwealth would cost them revenue. The reforms engaged in by the states to date were of a type designed to improve their budgetary position. The states made their agreement to competition policy conditional on Commonwealth compensation for consequent loss of revenue, and on progress in reducing the level of tied grants.

An impasse developed over this issue at the April 1994 COAG meeting (Painter, 1998, p.52). It was overcome by the Commonwealth agreeing that "all governments should share the benefit" and by instructing the Industry Commission to determine the share of increased Commonwealth revenues that should go to the states (COAG communiqué, 19 August 1994). The Commission's report provided computable general equilibrium model results that showed large GDP gains from implementing what it termed "Hilmer and related reforms". It also estimated that the reforms would increase state and local government revenues by 4.5 per cent, compared with a 6.0 per cent increase for the Commonwealth (Industry Commission, 1995, p.83).

The national competition policy reforms were agreed to at a COAG meeting in April 1995. As is dealt with in more detail in the next section, the agreement essentially involved a commitment by the Commonwealth and state governments to carry out a comprehensive program of reforms over a number of years in their particular jurisdiction. The agreement outlined the different areas to be reformed (or reviewed) under the overall national competition policy framework. While much of the detailed reforms were left to the states to initiate, it was agreed that there would be a series of competition policy payments to the states, conditional on the states meeting the timetable for reform. The states also gained a "permanent" arrangement under which the real per capita value of the annual general purpose grants they received would be maintained (Painter, 1998).

This was the high point of the collaborative federalism process in Australia. The reform program that was put in place has, by and large, been carried through. Given

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37 For example, the South Australian government were unwilling to pass over the control of its transmission system to a national electricity grid, or to allow free interstate trade in gas through a pipeline network (Painter, 1998, p.47).  
38 The Commission estimated that the reforms would increase Australian GDP by 5.5 per cent. This was a smaller projected increase than estimated by most previous studies, although larger than the 3.4 per cent estimate by Madden (1995) in a report commissioned by the Business Council of Australia, a major advocate of the reforms. Quigggin (1996 and 1997) challenged the Commission's computations as being very much an overestimate.
that it was arguably "the most comprehensive program of economic reform in the
country's history" (Samuel, 1999), it is perhaps not surprising that other large-scale
reform initiatives should make little progress while the competition policy program
was being worked through. Some progress has been made in terms of SPPs with the
removal of certain areas of overlap and duplication, although the states' major
demands for untying of grants has not generally occurred. In late 1995 political
reasons caused the states to drop their demands for a state income tax option and
focus their attention on seeking a tax-sharing arrangement. In late 1995 political
reasons caused the states to drop their demands for a state income tax option and
focus their attention on seeking a tax-sharing arrangement. In 1996 a federal Liberal government was elected. The Howard government was a
strong supporter of microeconomic reform, although their determination to generate a
surplus federal budget led to a retreat from the guarantee to the states on the level of
general purpose funding. During recent years the collaborative reform process has
moved more into the background with annual COAG meetings dealing with reforms
of a more detailed nature. The pressure to lower the degree of VFI has been reduced
as state governments have moved to sound financial positions after a decade of tight
expenditure control. Also state governments have been successful in their demand for
revenue sharing in a growth tax with the assignment of all revenue from the newly
introduced GST to state governments.

6. Microeconomic Reform

6.1 Mutual Recognition

Mutual recognition, which was agreed to in 1992 and implemented the following
year, was designed to remove state regulatory barriers that prevented both goods,
services and labour moving freely between Australian states. Under mutual
recognition, goods that met regulatory requirements in the state of origin could be
sold in another state, regardless of any conflicting regulations in the destination state.
Similarly, members of a regulated occupation in one state could enter an equivalent
occupation in another state without satisfying any additional requirements (Office of
Regulatory Review, 1997).

Mutual recognition "can increase competition, reduce business costs and lead to a
more dynamic and responsive economy" (Office of Regulatory Review, 1997, p. vii).
It also has value in a more globalised world by providing a basis upon which to form
mutual recognition schemes with other countries. Indeed, the Australian mutual
recognition reform was framed so as to incorporate New Zealand at an early stage.

Some exemptions to mutual recognition have been allowed for public health and
safety or environmental protection reasons. Legitimate reasons do exist for such
exemptions, such as to prevent the entry of a noxious weed into a state that is free of
the weed. States are allowed to make temporary exemptions unilaterally, with long-
term exemptions to be decided by a Ministerial Council who determine standards on
the basis of a two-thirds majority of state representatives. According to the Office of

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39 A federal election was about to take place and the federal Labor government was using the prospect of a state income tax as an election issue. Most state governments at this time were Liberal and thus concerned with the damage their calls for new tax arrangements might mean for their federal party's electoral prospects.
Regulatory Review there has only been a limited number of exemptions and it would appear that exemptions are not being used as a protective device.

The Office of Regulatory Review considers that mutual recognition has increased the level of interstate mobility of goods and occupations. For instance, a significant percentage of those registering for regulated occupations in various states are doing so under the mutual recognition provisions. However, it is difficult to determine whether any barriers to free interstate movement still exist.

6.2 National Competition Policy

The national competition policy agreement actually comprised three agreements: the Conduct Code Agreement (CCA), the Competition Principles Agreement (CPA) and the Implementation Agreement (IA). The CCA set up template Commonwealth legislation which the states would apply to their jurisdictions. It essentially extended Australia's competitive conduct (or anti-trust) rules to all areas of the economy, including previously exempt areas of GBEs and unincorporated enterprises. The CPA set out principles for overseeing the pricing policies of GBEs, ensuring competitive neutrality between GBEs and private sector competitors, structural reform of government monopolies, reviews of anti-competitive legislation, the formation of rules that allowed business to gain third-party access to the services of essential infrastructure, and the application of the CPA principles to local government. The IA provided for the disbursement over time of around $16 billion in federal incentive payments to the states to comply with the competition policy program.

A wide range of activities has been affected by the introduction of national competition policy. The reviews of anti-competitive legislation includes reviews of state and Commonwealth statutory marketing arrangements (that involve quantitative restrictions on a wide range of agricultural products), state government building regulations and approval processes, and state government-approved private monopolies in the taxi and newsagents industries. Reviews were expected to increase the extent of competitive tendering to provide general government services for both the Commonwealth and the states. State government legislation to extend competitive conduct rules to unincorporated enterprises would remove monopolies and restrictions within the legal and medical professions, in dentistry, optometry and pharmacy. Of particular importance to competitiveness would be the reform of state government GBEs in public utilities and ground and water transport, and Commonwealth GBEs in communications and air transport. For instance, the states were to establish an interstate electricity network to allow free trade in bulk electricity, to ensure cost-reflective electricity pricing, and to introduce competitive neutrality in GBEs' financing structure. In rail, states were to remove statutory monopolies, continue corporatisation, separately fund community service obligations and institute competitive neutrality in pricing. Port authorities were to be corporatised, regulatory and commercial activities separated, and berthing and other facilities were to be contracted out or privatised. Instances of planned Commonwealth reforms were the removal of Australia Post's monopoly in letter delivery, the ending of the legislated duopoly in telecommunications, and the achievement of a commercial return on non-regulatory services to aviation.
National competition policy has been in place now for almost seven years and many of the listed reforms have been undertaken. Extensive reviews are conducted by the National Competition Council (NCC) of Commonwealth and state progress in implementing the competition policy program. Three tranches of payments to the states in recognition of their reforms have been made. There have been instances where part of a payment to certain states has been delayed until a particular reform has been carried out, but these have been infrequent. The program is somewhat behind time, but significant reforms have occurred, particularly in the areas of GBEs. For instance, national markets in electricity and gas are largely in place, and a generic access regime has been introduced. GBEs are progressively adopting competitive neutrality and paying for community service obligations from funding received directly from the government's budget for that purpose. Markets in which GBEs operate are increasingly being made more contestable. A large number of GBEs have been corporatised and many have been privatised.

The degree to which these reforms are yielding the predicted welfare gains has not been comprehensively measured. Productivity Commission (1998) and Samuel (1999) provide extensive lists of price reductions in many areas. National competition policy would seem to have meant that state governments have allowed some of the productivity gains to be expressed in terms of lower prices for their GBEs output, rather than just aiming to improve their own budgetary position. Walsh (1993) had reported that funds from sales of state government assets had been partly used to maintain current expenditure, rather than financing infrastructure growth, replacement assets, or reducing net indebtedness. International standards in the reporting of government financial transactions, which have now been adopted by state governments, make such actions more transparent and help put pressure on governments to use properly the proceeds of asset sales. Under the new accounting standards, asset sales are recorded as negative capital investment. Also, probity auditors are now employed to ensure that asset sale proceeds are not inappropriately used.

7. Vertical Fiscal Imbalance Reform Bids

7.1 VFI - A problem?

VFI has been an area of public disagreement between the states and the Commonwealth for sixty years since the Commonwealth was handed control of all income taxation. How committed the states have been to their call for the reduction of VFI is a question considered in the following sub-section. The concern of the states has been mainly the pressure that VFI has placed on their revenue, and since the large-scale use of SPPs, on having to meet conditions relating to tied grants. It may be argued that VFI has remained because all levels of government have something to gain from it. It provides a way for the Commonwealth to institute policies in areas constitutionally assigned to the states, and it allows the states to take credit for their expenditure while avoiding the responsibility of fully funding that expenditure.

There is a considerable literature in Australia on the problems associated with the nation’s high level of VFI (e.g. James, 1992, Grewal, 1995, Mathews and Grewal, 1997, Painter, 1998, Walsh, 1992, 1993 and 1996b). Their criticism of VFI includes the following:
• centralised control of revenue has caused a centralisation of decision making that acts against the responsiveness to regional diversity that is at the heart of federalism;

• the intergovernmental grants system causes a “blurring” of responsibility and insufficient accountability to taxpayers for expenditure decisions;

• fiscal illusions are created as governments and voters fail to consider more than the own-revenue costs of state government expenditure;

• the pattern of public expenditure is distorted towards items that receive tied grant funding (the “fly-paper” effect);

• states are forced to rely on a narrow range of inefficient taxes;

• there is less scope for beneficial tax competition (of the sort that lowers excess burdens and compliance costs); and

• state taxes are perceived to act on business (Walsh, 1993), leading voters to underestimate the tax-cost of public expenditure.

The case against VFI is by no means incontrovertible. While there is some Australian evidence to support the fly-paper hypothesis (for example, Dollery and Worthington, 1999), this has been called into question by Brennan and Pincus (1998). They also question the degree of fiscal illusion. State voters are also federal voters and it is difficult to see why a system of grants that led to waste would continue to be supported by federal taxpayers. Furthermore, as has also been pointed by others (e.g. Moore, 1993), it is necessary to distinguish between the average and marginal costs of government outlays on state own-source revenue. Another area of dispute concerns the claimed benefits of horizontal tax competition for mobile factors of production, particularly when it frequently involves (often non-transparent) tax concessions on businesses (Productivity Commission, 1996). It is also debatable that the States do not have access to efficient taxes. Gabbitas and Eldridge (1998) suggest that state governments could make greater use of payroll taxes, particularly by broadening the base on which it is levied. In the long run payroll taxes and income taxes have similar efficiency, if not equity, effects.

The question of whether it is desirable to reform Australia's high level of VFI appears to be still an open one. Walsh (1996b, p.31) considers that "some of the worst features of state policies - including wasteful competition to attract new business development, attempts by states to become venture partners with the private sector, and other instances of regulatory policy failure - almost certainly have been induced

40 Even though this might not be their ultimate incidence.
41 On average Australian voters would not gain from a system that encouraged waste and presumably would not be in favour of the federal taxation required to support it. A federal political party that made this connection and offered to reduce transfers would presumably gain electoral support.
42 In 1998 only 8 per cent of private firms in Australia paid payroll tax. Gabbitas and Eldridge consider that the threshold level for payroll tax exemptions is far above that justified by the avoidance of significant administration and compliance costs.
by Australia's degree of imbalance in fiscal powers and by the associated lack of breadth and flexibility in the sources of revenues available to the states⁴³. To the extent that this is correct it is important that the question of VFI remains on the reform agenda.

7.2 State Income Tax

There have been four occasions when serious consideration has been given to income taxes once again being imposed at the state level (Sharman, 1993). The first occurred in the early 1950s when certain states challenged the legitimacy of the uniform tax legislation in the High Court. While that challenge failed, the High Court did determine that the states had the right to impose their own income tax. However, no attempt was made then or at any future points for the states to unilaterally impose their own taxes. On this and the second occasion the matter received attention, in 1969-70, the advent of more generous financial grants from the Commonwealth appear to have been sufficient to end the state governments move to re-enter the income tax field⁴³.

When in 1978 the Fraser government did enact legislation to allow the states to charge (pay) an income tax surcharge (rebate), it was at the instigation of the Commonwealth. The states' agenda had moved on. The rapid growth in SPPs in health, education, and urban development during the proceeding Whitlam government had shifted the states' concerns to the size and composition of Commonwealth grants (Grewal, 1995). In 1975, the Premiers requested that grants to the states be made on the principle of compensating the states for not having access to income tax revenue. The introduction by the Fraser government of a tax-sharing scheme in 1976 (see Section 4) may be considered a response to the Premiers' demand.⁴⁴ However, the 1978 Act allowing a state income tax surcharge (rebate) involved a reversal of roles between the Commonwealth and the states. The states showed no interest in taking up the opportunity provided by the enabling legislation. Despite reductions in SPPs and general-purpose capital funds, the states' financial position remained good. Sharman (1993, p.228) maintains that the states were concerned that the surcharge scheme "might help the Commonwealth escape from some of the odium for a high level of personal income taxes, and aid its attempts to wind back its financial commitments to the states." Proponents of a state income tax argue that the surcharge scheme could have been instituted in a way that would have induced the states to take advantage of it, but that the Commonwealth failed to give the states any tax room (Walsh, 1993). Mathews (1997) and Sharman (1993) argue that the only way to have made the system work would have been for the Commonwealth to reduce its income tax rate and, at the same time, to reduce its aggregate grants to the states by the amount of the revenue forgone.

The question of the distribution of tax powers arose again in the mid 1980s, when the Hawke government proposed options for a wide-ranging reform of the Australian tax system. While ultimately these reforms had to wait another 15 years for the advent of

⁴³ In 1970 a linkage drawn by the Commonwealth between VFI and being able to employ a satisfactory system of horizontal fiscal equalisation caused the smaller states to lose enthusiasm for a state tax. Then in 1971, the Commonwealth who raised the bulk of the pay-roll tax, effectively transferred the collection of that tax type to the states.

⁴⁴ Although not quite the one they were expecting (Grewal, 1995, p.22).
the GST, the prospect of such reforms (plus an adverse High Court decision on the legality of a Victorian fuel pipeline fee) led the states to form a working party on the issue. The Commonwealth became concerned that the states might begin to make use of the surcharge/rebate provisions and successfully moved to repeal the Act.

The main reason provided by the Commonwealth in repealing the income tax surcharge/rebate legislation was that it posed a danger to macroeconomic policy. However, this view was beginning to be seriously challenged at the beginning of the 1990s (Walsh, 1991, and Madden, 1993). Of particular importance was that the report of the Working Party on Tax Powers (1991) stated that a reduction in the level of VFI would not significantly damage the Commonwealth's capabilities in macroeconomic management or income distribution; since the working party comprised treasury officers from the Commonwealth as well as the states. Walsh (1993) considers that this was the first serious attempt by the states to regain an income tax capacity. Previous attempts he claims (Walsh, 1993, p.1) were no more "than an ambit claim designed ultimately to secure more generous grants". Certainly the states pursued the matter with vigour during the early years of the intergovernmental reform process. Sharman (1993, p. 232) argues that the states now saw "a state income surcharge as a logical extension of their arguments for greater state autonomy coupled with the possibility of greater financial security than the present system had given them". However, the latter can be satisfied by an arrangement for sharing revenue which, as was noted above, the states successfully pursued post-1995. While it is quite possible that some state premiers saw a state income tax as ensuring a more efficient federalism, it would seem that weakening the Commonwealth's fiscal dominance was a more likely goal. In any event, the states' motivation in pursuing the matter, particularly since they now have access to 100 per cent of GST revenue, would for the moment appear to have largely vanished.

7.3 Overlap and Duplication

While the states may have faltered in their pursuit of a state income tax, they have been more consistent in their determination to reduce one of the historical consequences of VFI, namely the level and conditions of tied grants. Prior to the introduction of the GST, state governments had campaigned to reduce substantially the share of SPPs in their total grants from their then current level of around 50 per cent. They have argued that SPPs result in duplication and overlap and see the solution in the Commonwealth largely abandoning control of areas already covered adequately by state legislation (Painter, 1998). The Commonwealth, however, wants to establish more effective collaborative arrangements in order for it to receive the best value from the funds it is providing in areas in which it has an interest.

There appears to have been little analysis of SPPs in terms of conventional public expenditure theory, such as to account for interstate spillovers from state government expenditure. While the states now recognise that there may be advantages in delivering certain programs through SPPs arrangements, they point to a number of disadvantages from such arrangements. These include "a lack of flexibility [in mechanisms for delivering government services], financial risk shifting to states, duplication of administrative costs, and a legalistic approach to agreements" (Tasmanian Treasury, 2001).
The advent of the GST intergovernmental arrangements (where after a transitional period the level of states' aggregate general purpose current funding is likely to be determined by the level of total GST receipts) would seem to further restrict the possibility of SPPs being reduced in favour of untied funding. However, some reforms have been made to the SPP system. The state and Commonwealth treasuries have developed a set of SPP Best Practice Principles, which are aimed at overcoming some of the problems outlined by the states. There have been major overhauls of specific areas, such as vocational training, that have led to fully integrated national systems that allow for a degree of state independence.\(^\text{45}\)

It has been argued that the more collaborative process involved in administering SPPs is no less intrusive than previous requirements for "matching" funds and other conditions (Craig, 1997). However, while SPP-funded projects that are jointly-planned between governments may still allow the Commonwealth to exert a strong influence on projects, the oversight of projects by Commonwealth officials in the comparison of project objectives to output-focussed performance targets may well increase the productive use of state government resources. While Commonwealth government managerialism may be having deleterious effects on the nature of federalism in Australia (Fletcher and Walsh, 1992), it would also appear to be bringing efficiencies in the production of public services.

8. **Conditions for Successful Reforms**

In section 5, some of the ingredients which led to the collaborative federalism reforms were discussed. In particular it was noted that the external balance and budgetary crises set the climate for economic reform for the Commonwealth and state governments respectively. Both governments began programs of microeconomic reform that were central to the shift towards collaborative federalism.

There has been some limited consideration given in the literature to the timing of Australia proceeding down the microeconomic reform path. Gerritsen (1992) maintains that the contracting of Australian manufacturing that had been occurring since the 1970s despite high levels of protection had disheartened private interests who were the beneficiaries of the market distortions. This allowed various advisers who had been putting the public interest case for many years, to gain the ascendancy. Gregory (1992) put forward a similar argument on the waning of support for protection, as it became clear that certain industries "would need ever-increasing levels of assistance if they were to maintain their market shares".

Gregory also argued that the poor performance of the Australian economy in the 1970s and 1980s had increased the demand for microeconomic reform in general. Dollery (1994) refined Gregory's argument by contending that when net rents to demanders and suppliers of regulation fell sufficiently, reform would occur.\(^\text{46}\) Thus, following Peltzman (1989) he shows that Australian deregulation can be explained within the theory of regulation. Dollery and Wallis (2000) contend that the arguments of Rodrik (1996) can be used to explain how distributional uncertainty has led to

\(^\text{45}\) See Painter (1998, pp. 159-73) for a detailed description of the formation of the Australian National Training Authority.

\(^\text{46}\) Dollery's argument relies upon unchanged costs of lobbying in a given industry - as explained by Dollery (1996) in a rejoinder to Quiggin (1995).
infrequency of reforms in Australia, plus some recent "reform fatigue", and that the Australian conditions (particularly the 1986 "crisis") allowed agents for change to persuade a majority of citizens to accept reform (as was the case in New Zealand; see Wallis, 1997).

While there were obvious incentives for microeconomic reform, the collaborative federalism move required additional ingredients. While the Commonwealth needed to include the states in its reform program, the states had other reasons for joining in the process. As noted above a major motivation for the states was a desire to improve their funding position. Other factors, also played a role, including characteristics of the political leaders involved in the process. Hawke had considerable abilities, experience and interest in consensus politics. All but one of the state governments belonged to the same political party as the federal government. The leader of the one Liberal state government was strongly committed to reform. The federal opposition supported the proposed intergovernmental reforms and potential losers from the reforms were not identifiable as a group that could effectively oppose reform. While factors such as political alignment and particular government leaders changed, the underlying motivations for reform maintained the momentum of collaborative federalism.

The overall success of the national competition policy and mutual recognition would appear to lie largely in the desire by both the centre and the state for the reforms. While the major national competition reforms have been delivered, some of the more minor reforms in the competition policy agenda have been delayed or diluted. In these instances there have been unified special interest groups who have been able to effectively exploit that part of the competition policy agreement that allows restrictions on competition to continue if removal of the restrictions are not justified by the public interest. While the public interest does include the efficient allocation of resources, under the agreement it also covers factors such as equity, ecology, safety and regional development. In some instances, state anti-competitive regulation review boards contain "balanced" numbers of interested parties, which mitigates against clearly disinterested judgements. However, in general, the reviews have worked well and have brought the anticipated deregulation.

In the case of areas relating to VFI, the limited extent of reforms would appear to arise from strong opposition from the centre, and from the objectives of the states not being clearly attached to removing the alleged distortions inherent in VFI, but rather in obtaining increased (untied) funding. Sharman (1993, p. 233) also notes that the SPP process has become deeply entrenched in government processes. Human capital is tied up in the current process and bureaucratic empires that have been built up to administer the SPPs represent a hidden opponent of change.

9. Regionalism

The 1990s have seen some re-emergence of regionalism. This occurred in two stages. In the early 1990s there was a plethora of reports on Australia's regions as the forces of globalisation began to impact on the structure of regional economies. Some of

47 It is worth noting that while there is general agreement that microeconomic reform should increase the productivity of the economy, it need not necessarily improve the current account position. This will depend on the public and private savings component of the GDP increase.
these reports dealt with ways of removing impediments to regional adjustment (e.g. Industry Commission, 1993), while others were concerned with ways of promoting regional development (e.g. Taskforce on Regional Development, 1993 and McKinsey & Co., 1994). Various regional development organisations were established. This had some similarities to Whitlam's regional policies of the 1970s. Walsh (1996a) speculates that Keating government was building up regional organisations in an attempt to weaken state governments. Whether such a motivation existed is difficult to establish; however, when the Howard government took office in 1996 the regional initiatives were largely phased out.

The Howard government had stated that there were a wide range of social safety nets and the like that should be adequate to deal with structural adjustment in regional Australia. However, there clearly was a policy vacuum with respect to the regions and the latter part of the 1990s saw a strong regional backlash against national competition policy reforms in particular. Much of this backlash was misplaced. A report by the Productivity Commission (1999) indicated that the bulk of the forces for change in declining and slow-growing Australian regions was connected with factors such as changes in the terms of trade, and not national competition policy.

However, a number of state governments lost office in the wake of regional objections to government economic reforms. This has resulted in slower progress in the implementation of competition policy and in what is now being termed "reform fatigue". Governments are now beginning to introduce actual compensation for reforms, for instance in the case of dairy deregulation, in order that certain reforms can proceed.

The Australian wage system is not conducive to smooth regional adjustment. Groenewold (1997) estimates that in the long run interstate migration does tend to eliminate differences in state unemployment rates. However, Australia's historic wage fixing system has meant that in the short run regional wages are unable to adjust to dampen negative (or positive) affects on regional unemployment. In recent years Australia's move towards enterprise bargaining is likely to have reduced this effect.

A question of interest is the role which fiscal equalisation might be affecting the degree of regional disparities. The degree to which HFE acts to reduce interstate disparities between household incomes has not figured in the Australian debate on fiscal equalisation for many years (Grewal, 1999). While the HFE process in Australia is aimed purely at offsetting fiscal disabilities, three of the recipient states (Tasmania, South Australia and Queensland) have had below average gross state product per capita for many years. On the other hand two of the recipient states (the Australian Capital Territory and the Northern Territory) have per capita gross state products considerably above the average.

In the long run the practice of HFE in Australia is likely to have had some effect on the pattern of state populations. An estimate of this effect can be made on the basis of results from simulations undertaken by Groenewold, Hagger and Madden (2001). They simulated a change in the distribution of Commonwealth grants under the assumption of interstate migration to equalise per capita utilities. Extrapolation of

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their results indicates, for instance, that abolition of HFE would in the long run increase Victoria's population by 1.5 per cent\textsuperscript{49}.

However HFE is likely to play only a very limited role in ameliorating the effects of economic shocks in the short term. Any stabilisation would occur with a lag, since the Commonwealth Grants Commission produces updated equalisation relativities only once a year, with a full review of their formula only every five years. Furthermore, while negative effects on a state's GDP is likely to increase a state's revenue disabilities and thus the level of its grants, the relationship is an indirect one and any counter-cyclical impact is an unintended by-product. It is doubtful that HFE assists in facilitating structural adjustment between Australian regions, since disability payments are of an ongoing nature. Furthermore, by operating primarily at the state level, HFE does not correspond well with the level of geographical areas which have been subject to the greatest degree of structural adjustment in Australia\textsuperscript{50}.

10. Competitive Federalism

While the states have willingly engaged in the intergovernmental reforms during the past decade, the collaborative processes have brought with it a further challenge to the states' autonomy. In putting their case for greater fiscal independence the states began to espouse the benefits of competitive federalism. Their argument was essentially that without greater financial independence the states would not be able to effectively engage in horizontal competition. While this gave an apparent economic efficiency argument to the states' attempt to have vertical fiscal imbalance lowered and special purpose grants replaced by general purpose ones, the degree to which such changes would bring about increased beneficial horizontal intergovernmental competition is uncertain. Forsyth (1995, p.71) contends that "the pattern of competition in Australia has given competitive federalism a bad name". Queensland Premier Wayne Goss (1995, p.7) in extolling the virtues of competitive federalism declared that "states compete 'horizontally' for jobs and investment through different regulatory, taxation, investment and expenditure policies". However, the competitive bidding engaged in by the states is likely to have merely shuffled jobs between regions, with probably an overall negative effect on Australian's welfare.\textsuperscript{51} The Productivity Commission (1995) raises concerns that most state budgetary assistance to industry is selective, discretionary and non-transparent. It could also be argued that some of the VFI resulted from tax competition eroding the states' tax base, as was the case with the rapid abolition of death duty once one state (Queensland) abandoned the tax in the 1970s.

\textsuperscript{49} In the Groenewold et al model all households in a region are identical, so that marginal utility equals average utility. In such a world HFE has no effect on relative regional disparities. In an actual world of heterogeneous households, infra-marginal households in the recipient states gain from the redistribution.

\textsuperscript{50} Lloyd, Harding and Hellwig (2000) show that income variations within states can be more important than across states.

\textsuperscript{51} Madden (2002) shows that it is possible that a major largely unanticipated event might cause a welfare gain to both the state attracting the event and to the other states if the event results in the use of sufficient previously unemployed resources. However, there are probably few cases which have the characteristics that would result in selective state level assistance bringing a gain even to the instituting state (Productivity Commission, 1995).
However, while collaborative federalism may have in some ways strengthened the Commonwealth's fiscal dominance, it has also brought a form of horizontal intergovernmental competition that appears to be of clear benefit to economic efficiency. The actual process of NCP reforms, with its attendant incentive payments for adhering to the reform program, has put in place national markets for such products as electricity and gas in which GBEs from various states, and newly privatised enterprises, compete. The Commonwealth Treasury prepares competitive indices for each state that has set up another public performance indicator which encourages state governments to compete against each other for electoral reasons. One of the most important forms of quasi-competition is in terms of financial management, where states acknowledge credit ratings from international agencies as important in attracting international capital to their state.

11. Concluding Remarks

Australia is a long established federation with some specific institutional features such as the Loan Council and the Commonwealth Grants Commission. While there was little reform of the federation over its first three-quarters of a century, there was a continual increase in the level of the fiscal dominance by the federal government.

Those reforms attempted in the 1970s largely reflected the political positions of successive federal governments towards federalism. Labor had a long standing anti-federalism stance, which during its period in government in the early 1970s, it translated into a large increase in tied grants to the states and a policy of administrative regionalism (where regions were at a sub-state level). Labor's regionalism push was seen as an attack on federalism. The state income tax reforms introduced by the following Liberal government were largely part of an attempt to redress the balance and provide the states with more financial independence. Both governments' "new federalism" reforms failed. There was no group that strongly supported regionalism which was strongly opposed by the politically powerful states. The state income tax reforms were introduced in a form that meant they were unlikely to be actually used by the states.

However, during the 1980s fundamental forces began to arise which put pressure on Australia's federal structure. Federal government fiscal restraint in the face of Australia's greater use of overseas capital markets, falling world prices for its exports, and continued competitive pressure from imports, fell heavily on grants to the states. The international intellectual climate for deregulation began to make in-roads into Australia. State governments' financial positions also began to deteriorate due to imprudent initiatives in economic development and state banking, and international credit agencies began to lower the credit ratings of a number of states. These pressures resulted in the establishment of a comprehensive program of intergovernmental reforms within a collaborative federalism context.

The reform process has delivered a dismantling of interstate regulatory barriers (mutual recognition) and a raft of national competition reforms which, in particular have increased efficiency in the traditional areas of government business enterprise - the utilities, transport and communication. Vertical fiscal imbalance remains but the states now have a 100 per cent share of the new goods and services tax which has
enabled them to vacate a number of very inefficient taxes that were subject to large changes in their base from global economic forces.

While the collaborative federalism process has left the states with a continued financial dependence on the federal government, it has increased the efficiency of both state governments and their business enterprises. Following the recession of the 1990s the Australian economy has grown at above the OECD average and has enjoyed one of its strongest growths in productivity. The collaborative federalism reforms appear to have played a significant role in this. However, some reform fatigue is setting in, particular in the wake of a backlash from rural and regional Australia. Further federalism-related reforms required for a continuance of Australia's restructuring to enable it to respond well to structural adjustment pressures are a review of state government industry assistance and further reforms of federal and state industrial relations institutions.
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Figure 1: Map of Australian States and Territories
### Table 1: Basic Features of Australian States and Territories, 2000-01

<table>
<thead>
<tr>
<th>State</th>
<th>Area '000 km²</th>
<th>GDP $billion</th>
<th>Population million</th>
<th>GDP/head $'000</th>
</tr>
</thead>
<tbody>
<tr>
<td>New South Wales</td>
<td>801.6</td>
<td>231.3</td>
<td>6.533</td>
<td>35.4</td>
</tr>
<tr>
<td>Victoria</td>
<td>227.6</td>
<td>164.4</td>
<td>4.829</td>
<td>34.0</td>
</tr>
<tr>
<td>Queensland</td>
<td>1727.2</td>
<td>103.8</td>
<td>3.628</td>
<td>28.6</td>
</tr>
<tr>
<td>South Australia</td>
<td>984.0</td>
<td>41.6</td>
<td>1.502</td>
<td>27.7</td>
</tr>
<tr>
<td>Western Australia</td>
<td>2525.5</td>
<td>68.1</td>
<td>1.910</td>
<td>35.7</td>
</tr>
<tr>
<td>Tasmania</td>
<td>67.8</td>
<td>11.3</td>
<td>0.470</td>
<td>24.0</td>
</tr>
<tr>
<td>Northern Territory</td>
<td>1346.2</td>
<td>7.8</td>
<td>0.198</td>
<td>39.4</td>
</tr>
<tr>
<td>Australian Capital Territory</td>
<td>2.4</td>
<td>13.1</td>
<td>0.314</td>
<td>41.7</td>
</tr>
<tr>
<td>Australia (a)</td>
<td>7682.3</td>
<td>641.4</td>
<td>19.384</td>
<td>33.1</td>
</tr>
</tbody>
</table>

(a) Australian population figure excludes Commonwealth administered territories

Source: Australian Bureau of Statistics, Australian Economic Indicators (May 2002) and Year Book Australia 2001
Figure 2: Australian Real GDP Growth
<table>
<thead>
<tr>
<th>Category</th>
<th>Share (per cent)</th>
<th>Total Expenditure $billion</th>
</tr>
</thead>
<tbody>
<tr>
<td>Commonwealth government</td>
<td></td>
<td></td>
</tr>
<tr>
<td>General public services</td>
<td>51</td>
<td>19.046</td>
</tr>
<tr>
<td>Defence</td>
<td>100</td>
<td>11.327</td>
</tr>
<tr>
<td>Public order and safety</td>
<td>14</td>
<td>10.745</td>
</tr>
<tr>
<td>Education</td>
<td>5</td>
<td>35.777</td>
</tr>
<tr>
<td>Health</td>
<td>46</td>
<td>41.179</td>
</tr>
<tr>
<td>Social security and welfare</td>
<td>91</td>
<td>72.059</td>
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<tr>
<td>Housing and community amenities</td>
<td>28</td>
<td>10.583</td>
</tr>
<tr>
<td>Recreation and culture</td>
<td>31</td>
<td>6.592</td>
</tr>
<tr>
<td>Fuel and energy</td>
<td>70</td>
<td>3.760</td>
</tr>
<tr>
<td>Agriculture, forestry and fishing</td>
<td>45</td>
<td>3.857</td>
</tr>
<tr>
<td>Mining, manufacturing and construction</td>
<td>55</td>
<td>1.876</td>
</tr>
<tr>
<td>Transport and communications</td>
<td>15</td>
<td>15.549</td>
</tr>
<tr>
<td>Other economic affairs</td>
<td>46</td>
<td>6.586</td>
</tr>
<tr>
<td>Total</td>
<td>52</td>
<td>238.936</td>
</tr>
</tbody>
</table>

(a) Currently this category only includes universities.

### Table 3: Own-Source Revenues by Government 2000-01, $billion

<table>
<thead>
<tr>
<th></th>
<th>Commonwealth government</th>
<th>State governments</th>
<th>Local governments</th>
<th>Multi-jurisdictional(a)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income taxes</td>
<td>120.885</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Payroll taxes</td>
<td>3.577</td>
<td>9.517</td>
<td>0</td>
<td>0</td>
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<tr>
<td>Taxes on property (b)</td>
<td>0.012</td>
<td>12.429</td>
<td>6.388</td>
<td>0</td>
</tr>
<tr>
<td>GST(c)</td>
<td>25.830</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Excise &amp; levies</td>
<td>19.470</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Taxes on international trade</td>
<td>4.606</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Taxes on gambling</td>
<td>0.006</td>
<td>3.547</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Taxes on insurance</td>
<td>0.000</td>
<td>5.966</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Motor vehicle taxes</td>
<td>0.000</td>
<td>4.030</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Franchise taxes (d)</td>
<td>0.000</td>
<td>0.325</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Other taxes</td>
<td>0.655</td>
<td>0.354</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Income from GBEs</td>
<td>2.939</td>
<td>5.364</td>
<td>0.003</td>
<td>0.013</td>
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<tr>
<td>Other revenue</td>
<td>4.465</td>
<td>5.621</td>
<td>1.577</td>
<td>1.394</td>
</tr>
<tr>
<td>Total</td>
<td>182.445</td>
<td>47.153</td>
<td>7.968</td>
<td>1.407</td>
</tr>
</tbody>
</table>

(a) Currently only universities treated under this heading
(b) Includes taxes on financial and capital transactions
(c ) In 2000-01 includes $1.976 billion in sales taxes payable on 1999-00 transactions
(d) Taxes incurred in 1999-00


### Table 4: Total Commonwealth payments to state and local governments (As a percentage of GDP)

<table>
<thead>
<tr>
<th></th>
<th>1997-98</th>
<th>2000-01</th>
</tr>
</thead>
<tbody>
<tr>
<td>General purpose payments</td>
<td>3.0</td>
<td>-</td>
</tr>
<tr>
<td>GST revenue provision to the states</td>
<td>-</td>
<td>4.0</td>
</tr>
<tr>
<td>Budget balancing assistance</td>
<td>-</td>
<td>0.4</td>
</tr>
<tr>
<td>National competition policy payments</td>
<td>0.0</td>
<td>0.1</td>
</tr>
<tr>
<td>Special revenue assistance</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td>Specific purpose payments 'to' the states</td>
<td>2.0</td>
<td>2.2</td>
</tr>
<tr>
<td>Specific purpose payments 'through' the states</td>
<td>0.6</td>
<td>0.7</td>
</tr>
<tr>
<td>Specific purpose payments direct to local government</td>
<td>0.1</td>
<td>0.1</td>
</tr>
<tr>
<td>Total Commonwealth payments to the states</td>
<td>5.8</td>
<td>7.5</td>
</tr>
</tbody>
</table>

Source: Derived from Commonwealth Treasurer Budget Paper No.3 (2001-02), Australian Economic Indicators (May 2002)