COMPETITIVE FEDERALISM

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(A) single courageous State may, if its citizens choose, serve as a laboratory; and try novel social and economic experiments without risk to the rest of the country.[1]

Federalism is about competition among the States. It serves not so much to empower the States but to discipline them.[2]

Tax competition among States rather than tax collusion is an objective to be sought in its own right.[3]

Reform consists in taking a bone from a dog. Philosophy won't do it.[4]

Introduction

The practical implementation of competitive federalism has been ignored, if not shunned by all parties both at federal and state levels. Labor hates the idea of federalism. Is it any wonder that Australian productivity rates for several years were stationary and are now shrinking.

Long overdue is the need for rigorous fiscal discipline to be imposed through competition among the States.

The aim of this essay is to show how competition between the states is an essential element in improving national productivity. To achieve this increase in productivity voters need to embrace the idea of limited Government. It is directly opposed to the present received wisdom of the 'nanny state,' where every ill or disadvantage is to be cured by Government. As Goethe said, 'the best government is that which teaches us to govern ourselves.'

First, the present productivity position is considered. Secondly, the effect of too much taxation and spending is discussed. Thirdly, the need for the reassignment of taxation powers to produce effective tax competition among the states is examined. Fourthly, the creation of new states as a way of improving federalism and increasing competiveness especially in the context of the proposed development of Northern Australia is remarked upon. Finally, the futility of continuing with the Council of Australian Governments (COAG) is scrutinized.

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Productivity and federalism

Increasing productivity is fundamental to economic growth and prosperity. It also underpins the nation's defence capacity and its survival.

For 2011, of the 34 countries in the OECD, the rankings of GDP per hour worked at current prices put Australia at 13th with $US 49.10 per hour compared with the top ranking of Norway at $US 83.00 per hour. The United States was ranked fourth at $US 60.20 per hour. In other words Australian productivity is about 60 per cent of Norway's and 80 per cent of the United States.[5]

> *We have lower average incomes than the Americans not principally because we work less, but because our productivity is significantly lower. Our average incomes are lower because our work is worth less — and not just less than in the United States.*[6]

By State the Gross State Products (GSP) in $'000 per person for 2012 were as follows:[7]

W.A.	99
N.S.W.	61
Qld.	61
Vic.	57
S.A.	55
Tas.	48
A.C.T.	86
N.T.	78
Cth.	64

Other than Western Australia, all of the States recorded GSP per person figures below the Australian average. New South Wales, Queensland and Victoria were about 60 per cent of that for Western Australia. Tasmania was less than one half. Seemingly the seat of Government in Canberra bears the character of a 'special economic zone' with a GSP of $86,000 per person.

The following figures have been derived from statistics [8] produced by the Australian Bureau of Statistics (ABS) to compare the GSP per hours worked by States and Territories. No official ABS statistics of this kind are produced, nor do there appear to be any official figures produced by the States. In short neither the Commonwealth nor the States seem to know the score. All of which appears to show an unsatisfactory approach to improving productivity.

Gross State Products ($’000) per hours worked for 2012 were as follows:

W.A.	107
N.S.W.	74
Qld.	69
Vic.	68
S.A.	67
Tas.	65
A.C.T.	92
N.T.	83
Cth.	75

Labour productivity reflects not only the contributions of labour but also takes into account the contribution of capital and other factors of production. The standout figure is Western Australia at $107,000 per hour, compared with the Rest of Australia at $71,000 per hour. It was 51 per cent greater.

So far as the contribution from the Queensland mining sector is concerned the alarm bells should be ringing with a multifactor productivity decline of 9 per cent per year for the ten years to 2012. [9]

Imagination and innovation are the keys to improving long term productivity, as is the provision of high quality infrastructure. The ABS produces a multifactor productivity (MFP) statistic on a national basis and says that:

> *(I)n the long term it represents improvements in the ways of doing things (technical progress), which is the primary source of real economic growth and higher living standards. In the short term however, multifactor productivity also reflects unexplained factors such as cyclical variations in labour and capital utilisation, economies of scale, and measurement error.*[10]

The most recent MFP figures show a decrease of 2.7 per cent in 2009 over 2008 after several years in which the productivity index had plateaued.[11] Disturbingly there appear to be no corresponding official figures produced and published on a state by state basis.[12] As the famous management consultant and educator Peter Drucker said, “if you can’t measure it, you can’t manage it.”

Too much taxing and spending.

For 2012, the Government sector represented about 23 per cent of GDP of $1.5 trillion at current prices. Because of vertical fiscal imbalance there is a significant transfer of funds from the Commonwealth Government to State Governments.

These figures conceal the true involvement of the public sector in the economy when the proportion of taxation is calculated. A different result is found when looked at from a national income perspective. The eminent and omniscient economist Colin Clark remarked:

> *The customary practice of measuring taxation and expenditure as percentages of the Gross National Product (sic GDP) is to be deplored. By raising indirect taxation you raise Gross National Product, and thereby appear to reduce the percentages. This is not the case if National Income at Factor Cost is used as the base.*[13]

For the 2012 financial year all Australian taxes levied were $395 billion[14] which represented 31 per cent of Gross Domestic Product at factor cost of $1.3 trillion.[15] Colin Clark reckoned intuitively and which he supported empirically, that growth would decline if taxation, 'in all its forms' was more than 25 per cent of the net national income at factor cost. A proposition with which Lord Keynes appeared to accept.[16] Clark's hypothesis seems to be established, if decreasing productivity is taken as signalling a period of low growth. Drucker thought that 'the evidence would indicate that it might be closer to 40 than to 25 per cent.'[17]

When consumption of fixed capital of $227 billion,[18] (i.e. depreciation of fixed assets) and net income payable overseas of $ 45 billion are deducted, then the National Income (i.e. net national disposable income) is $1.1 billion and on this basis taxation would represent 37 per cent; - 75 years ago it was 18 per cent. Significantly this exceeds Clark's 25 per cent benchmark by a factor of 50 per cent.

Winding back spending by Commonwealth, State, Territory and Local Governments is needed to reach Colin Clark's 25 per cent benchmark. Here it would be useful to adopt the technique of 'zero based budgeting' as modified for the public sector. The introduction of such a technique should encourage administrators to take a hard look at incremental spending. Hopefully it might cause a re-examination and justification of present discretionary programmes.

By their unceasing efforts in increasing regulation, Government's unnecessarily burden businesses with extra administrative costs making them less productive and profitable.

> *Taxing, spending and regulatory functions should be exercised by lower levels of government unless a convincing case can be made for assigning them to higher levels of government.* [19]

All of this results in lessening their capacity to employ. What is startling, is a lack of relevant data to measure productivity in the Government sector, namely health, education and training, and public administration and security.[20]

Tax competition between the States.

The eminent constitutional lawyer Geoffrey Sawer pithily explained vertical fiscal imbalance when he said: ‘those who tax do not have to justify the expenditure and those who spend do not have to justify the taxation.’ [21]

Presently, the Commonwealth raises more than 80 per cent than of all taxation revenue in Australia, leaving the States with less than 20 per cent to fund their responsibilities. That part leaves them with less than half of the revenue needed to do this. The balance is supplied by Commonwealth grants, too many of which come with conditions attached.

Unless the States become responsible for raising the taxes needed to fund the activities for which they are primarily responsible, like education and health it will be impossible for effective tax competition to start. The Commonwealth’s invasion of State activities for more than fifty years needs to be reversed. It should not be overlooked that roughly 90 per cent of the value of the public physical assets in Australia are owned by the States; e.g. schools, universities, hospitals, roads, bridges, etc. The Commonwealth’s main physical public assets are in defence assets like, aircraft, warships including submarines (of which one third are under long term repair) , armoured fighting vehicles and artillery weapons. They have little if anything to do with productivity.

Pathetically, it is generally accepted that the present federal fiscal arrangements are dysfunctional. Those who are responsible for this fiasco do not have the courage to fix it. Their spines are like chocolate éclairs.

For the States to match their spending with their taxing, the Commonwealth must give up its taxation of personal income and allow the States to fix their own rates of income tax. Administratively the tax could be collected by the Commonwealth as agent for each State. This kind of arrangement, operated before1942, albeit in reverse, when State Taxation Departments collected income tax on behalf of the Commonwealth. What is critical is that each State must legislate for its own rates of tax, whether at progressive rates, a flat rate or as a surcharge on the Commonwealth’s tax. [22]

Under this arrangement company income tax would continue to be levied and collected by the Commonwealth. It may also require an overdue review of the taxation of trust income.

Part of this re-arrangement may result in the Commonwealth keeping the Goods and Services Tax for its own purposes, rather than distributing it to the States. A collorary of this rearrangement must be for the Commonwealth to stop making 'tied grants' to the States by overreaching its powers under s.96.

State Governments should abolish payroll taxes, stamp duties and land taxes, as was originally accepted in 1999 when the GST rate was agreed with the Commonwealth.

Hopefully the end result might be an Australia with six States levying significantly different rates of personal income tax. It would also give each State the capability of creating development zones for the levying different rates of tax. In the case of the Commonwealth this kind of concession is impermissible because it would discriminate between parts of a State; s. 51(ii) and s.99 of the Constitution.

It is possible that a resource rich State might be in a position to choose to not levy personal income tax like Texas.

A premise on which competitive taxation is based is that citizens are mobile because they are prepared to move to a lower taxing state, if the state in which they currently reside taxes excessively. This is the discipline which the citizen can impose upon the state.

An inkling of the potential of competitive federalism is to recall what happened in the late 1970s when Queensland abolished death duties. There was an immediate emigration of wealthy citizens from the Southern States to Surfers Paradise and or transfer of assets to Queensland. Soon afterwards all of the States abolished death duties and the Commonwealth abolished its estate and gift duties for persons dying or making gifts on or after 1 July 1979.

Collusion between the States in agreeing to impose the same taxation rates is more likely where there are few States such as in Australia. In other words the likelihood of collusion varies inversely with the number of States. If this is correct then it seems that there a case might be made for the creation of new States as provided for in Chapter VI of the Constitution. For example the creation of City States and Rural States.

New States under Chapter VI of the Constitution.

Professor Geoffrey Blainey has noted that the newest state created in Australia is Queensland.

> *Australia has created no new state since 1859: the United States in contrast has created close to 20. For a land of this size we do not have enough states. We thus miss one of the advantages of federalism.*[23]

At the First Federal Convention in 1891, Queensland separationists demanded that Queensland be admitted to the Commonwealth as three separate states. Queensland is the only state in which there have been three parliamentary resolutions in favour of subdivision as in 1910, 1922 and 1948.[24]

Sir Samuel Griffith introduced the *Queensland Separation Bill 1894* to divide Queensland into three provinces, South, Central and North Queensland, to be called the United Provinces of Queensland.

On 22 December 1910 the Legislative Assembly of the Queensland Parliament resolved:

> *That in the opinion of this House, the time has arrived when Queensland should be divided into three States, and when Central and Northern Queensland should each be granted separate Constitutions subject to the Constitution Act of the Commonwealth of Australia.*[25]

It was envisaged that there would be a State in the tropical north centred on Townsville, a State in the semi-tropical centre based on Rockhampton and a State in the temperate South with Brisbane as the capital.

Whether there should be additional States was spoken of by the Governor of Queensland in opening Parliament, on 17 August 1948, when he said:

> *To have a properly balanced Commonwealth Parliament it would be advantageous to have at least three States across the northern parts of the continent, each with representation in the Federal House. It was with that end in view that the Premiers of Queensland and Western Australia waited on the Prime Minister to secure the appointment of a Northern Australia Development Committee which has been formed and is now planning for the development of the North.*
>
> *My Advisers are prepared to recommend the establishment of additional States in Queensland when as a result of their developmental policy, the new States will have a reasonable degree of financial and economic stability.*[26]

On 21 June 2013 the Liberal National Federal Coalition published its Green Paper setting out its *2030 Vision for Developing Northern Australia.*[27] On attaining Government it undertakes to produce a White Paper with a plan to maximise the development of the North 'through private sector investment and ingenuity.'

The 1948 *Northern Australia Development Committee* bears a great deal of similarity with the idea of a *Northern Australia Partnership* comprising the Prime Minister, the Premiers of Queensland and Western Australia and the Chief Minister of the Northern Territory.

In preparing the White Paper consideration might be given to parts of Queensland and Western Australia being surrendered, leased, or sold to the Commonwealth [28] so that they become Territories of the Commonwealth. As Territories there would be no constitutional bar to tax discrimination under s. 51(ii) or s. 99 of the Constitution in providing reduced income tax rates or rebates for persons living north of the Tropic of Capricorn. It would avoid any challenge to the idea of zone tax concessions.[29] On the expiry of the leases, these territories might be re-established as new States.

Alternatively Western Australia and Queensland might consider creating new territories in the north of their respective States as a forerunner to their eventual statehood.

The futility of COAG.

With the enactment of the *COAG Reform Act* 2008 (Cth) and the *Federal Financial Relations Act* 2009 (Cth), Parliament sanctioned Executive Federalism. It is the product of Intergovernmental agreements between the Commonwealth and the States and the Commonwealth's financing of these agreements. This scheme is founded on the 2009 *Intergovernmental Agreement on Federal Financial Relations* and a delegation of Parliamentary power under s 96 to the Executive.

Its working is illustrated by the $16.2bn, *Building the Education Revolution* programme in making grants to the States for multi-purpose halls, libraries and class rooms for primary schools ($14.1bn), science and language centres for secondary schools ($0.8bn) and minor capital items in the national school pride program ($1.3bn). All for non Commonwealth purposes.

This program was established by Schedule D of the *National Partnership Agreement on the Nation Building and Jobs Plan* made by the Commonwealth, States and Territories on 5 February 2009.

Intergovernmental agreements and National Partnership Agreements are political agreements. They are unenforceable domestic treaties made between the States' Executives and the Commonwealth Executive. They are not laws of any State, Territory or of the Commonwealth.

Presently there are six national agreements, and more than 140 National Partnerships Statist agreements of this kind deny competitive federalism. They can only be made because the Commonwealth raises more money than it needs.

The abolition of COAG will be the turning point to increasing productivity. It will give the States the opportunity to pursue what Justice Brandeis's said of 'trying novel social and economic experiments' against Canberra's edict of 'one size fits all.'

Conclusion

If the Australian economy is to avoid a long period of low economic growth or worse still, stagflation, after the end of the mining boom, then it needs to be reinvigorated by significant and sustainable increases in productivity. This will only come about by the each State becoming more productive. This is where the work is done.

A first step is to collect and publish relevant productivity statistics. What seems to be an extraordinary situation is that neither the Commonwealth nor the States publish officially, Gross State Product per hours worked and multifactor productivity statistics. To repeat Peter Drucker's maxim, 'if you can't measure it, you can't manage it.'

Next, there needs to be a reduction of taxation and government spending to get it down from 37 per cent to about 25 per cent of the net national income. There needs to be an audit, by a constitutional censor, of all Commonwealth legislation with the aim of recommending the repeal of Acts and Regulations which duplicate or interfere with State functions. The idea of taxation and expenditure limitations needs to become accepted doctrine. Less is more.

The States must have the power to fix personal income tax rates. No objection ought be taken to the Commonwealth administering these taxes and collecting them as agent for the States.

Consideration needs to be given to the creation of new States. The coalition's vision for the development of Northern Australia offers a good opportunity for this to occur.

Further, the abolition of COAG is a necessary prerequisite for the States to regain the full administration of functions like education and health.

> *Real federalism requires confidence in the creative energies of a free society; a healthy suspicion of interest group schemes and a willingness to tolerate uncertain and diverse results.*[30]

The nations ultimate survival depends upon sustainable productivity increases brought about by an increase in competition among the States.

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3232 Words excluding 692 endnotes.

Endnotes

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[3] Geoffrey Brennan and James M. Buchanan., *The Power to Tax – analytical foundations of a fiscal constitution*, (1980), 186.

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[14] Table 39 – Taxes: ABS 5206.00 Australian National Accounts: National Income March 2013 at p. 58.

[15] Tables and 13 12 – Income from GDP: ABS 5204.00 Australian System of National Accounts: 2012 at pp. 36-37.

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18 Table 13 National Income Account: ABS 5204.00 Australian System of National Accounts: 2012 at p. 37.

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28 C.f. the surrender on 7 December 1907 of the Northern Territory by South Australia to the Commonwealth under the *Northern Territory Acceptance Act 1910* (Cth).

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