Submission to the National Commission of Audit:

Reform of roles and responsibilities of Commonwealth, State and Territory Governments

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Introduction – Constitutional Background and Summary of Submission

The Framers of the *Australian Constitution* intended to create a small federal government: to retain the legislative and fiscal autonomy of the States, subject only to the necessary expenses of the Commonwealth within its limited areas of competence. With this object in mind, the colonial Premiers contemplated meeting the entire expenses of the Commonwealth out of the revenue from import duties on goods. Indeed, provision was even made for the transfer of any 'surplus' in federal revenue back to the States. The operation of the Australian Federation is vastly different a century later, with legislative and fiscal power having been centralized, although the legal architecture for Commonwealth/State relations remains largely the same.

Assumptions in the early years of the nation that there were protected areas of residual State legislative power quickly faded. The limited list of legislative powers allocated to the Commonwealth Parliament in sections 51 and 52 of the Constitution has received a broad interpretation. Successive federal governments of all persuasions have explored the extent of the Commonwealth's legislative powers (in particular with respect to trade and commerce in section 51(i), corporations in section 51(xx) and external affairs in s 51(xxix)) and through legislative have expanded central regulatory influence into new areas such as environmental protection, workplace relations, and human rights protection.

The fiscal ascendancy of the Commonwealth over the States commenced from the imposition of the uniform tariff in 1901. The introduction of a federal income tax during WWII marked another dramatic change to State revenue-raising, with the States forced to vacate this field of taxation. The High Court's increasingly restrictive excise decisions contributed to further restrictions on State revenue raising capacity in the mid-1990s. The Court has greatly reduced the ability of the States to raise revenue through licence fees in industries such as tobacco, alcohol and petrol.

As is well known, Australia's vertical fiscal imbalance is high by world standards. Commonwealth fiscal power has been leveraged to increase the scope of Commonwealth regulatory power through tied grants (made pursuant to a broad grants power in s 96 of the Constitution) in the areas of health, schools, skills and workforce development, disability services and affordable housing.

In addition to s 96 grants made through the States, the Commonwealth has relied heavily on direct funding programs as a form of regulation to achieve its policy objectives, for example, in the National School Chaplaincy Program, and the Roads to Recovery program. However, the High Court has recently indicated that the Commonwealth's regulatory capacity through its spending and contractual capacity is more limited than previously understood. While the Commonwealth has attempted to continue these programs, this is an area ripe for further review and reform.

In this submission we do not advocate for constitutional amendment to achieve reform of Australia's federal system (such as, for example, replacing the States with small, regional governments as has been advocated from time to time). Constitutional change is difficult, and would require a much longer and more involved consultation process and public education campaign around the role of government and the benefits to be harnessed through a federal system. In any case, we believe that Australia can be a vibrant and effective federation under its current constitutional structure.

We draw attention to the possible reforms that can be achieved within the current constitutional framework. There are important policy choices to be made in determining how much of the legislative, fiscal and regulatory power available to the Commonwealth should be exercised in practice.

Our submissions as to the content of these reforms are informed by a number of principles. We believe that the dispersal of power inherent in a federal system ought to be harnessed to promote diversity, innovation and competition among the States and to promote greater democratic participation and responsiveness. However, the importance of central regulation must also be recognised to ensure efficient and effective service delivery and equality of core services amongst the States of the federation.

Against this background, this submission proceeds in three parts:

Part 1 – Redrawing the division of responsibility between Commonwealth and States

Part 2 – Rethinking the States' tax-base and equalisation within the federation

Part 3 – Reform of cooperative federalism mechanisms

Part 1. Redrawing the divisions of responsibility between Commonwealth and States

As indicated above, over the course of the last century, Australia's federation has become increasingly centralised, through broad interpretations of the Commonwealth's legislative and fiscal powers. The Commonwealth has consistently used these broad readings to extend its sphere of responsibility into areas such as human rights protection, environmental protection, law and order and industrial relations.

We suggest that the Commonwealth's legislative expansion into the outer limits of its powers should not be viewed as a necessary corollary of the High Court's generous approach. Further, neither do the restraints in the breadth of the grants of Commonwealth power necessarily have to restrict federal regulation of areas. For example, s 51(xxxvii) of the Constitution provides that the Commonwealth has power to make laws where the States have agreed, and referred that power to the federal Parliament. This occurred, for instance, in late 2008 when the State Governments agreed to refer legislative power to the Commonwealth for the purpose of allowing the Murray-River Basin to be managed at a federal level, which resulted in the enactment of the *Water Act 2007* (Cth) and subsequent amendments to it. By the States referring power, it removed any doubt over whether the Commonwealth could legislate on its own in an area where it was general agreed central intervention was necessary. The referral eliminated the risk of a challenge to the legislation on that basis at some later point in time. The referral also made the process more inclusive, with the involvement of the different levels of government; although in the case of the Murray, it did not necessarily remove the tensions between the Commonwealth and the States.

Presently, the division of the Commonwealth's legislative powers tells only part of the story of the division of responsibility across the Australian federation. The Commonwealth has relied heavily on two mechanisms to regulate and achieve its policy objectives: tied grants and direct funding programs.

Under s 96 of the Constitution, the Commonwealth Parliament can make grants to the States on any conditions it sees fit. The High Court has consistently held that the grants power in s 96 is not limited to the Commonwealth's heads of legislative power and there are very few restrictions on the types of conditions that can be attached. Currently, the Commonwealth makes large block grants to the States, Specific Purpose Payments (SPPs), in the areas of health, schools, skills and workforce development, disability services and affordable housing. The grants are dependent on States agreeing to certain outcomes and accountability measures. Alongside the SPPs are an increasing number of National Partnership Programs (NPPs), which are grants that are more closely regulated by the Commonwealth.

Commonwealth-State grants are an important mechanism in a federal system. Such grants can be used to achieve a desired level of equalisation across the States to ensure minimum levels of services are available to individuals across the federation. They can also be used to implement cooperative schemes in areas where a level of congruence is desirable, for example where the central government provides funding in areas subject to a broad framework, while States are responsible for implementing the program with discretion and flexibility to tailor it to local needs and expectations. Such a model would pick up some of the characteristics of German federalism. Under the German system, the central government has exclusive, concurrent and framework jurisdictions. Framework laws lay down basic principles and leave the Länder (States) free to elaborate on the detail in their local implementation.

However, tied federal grants can also lead to a failure of federalism. They can create disparity between responsibility and resources. It is inherently inefficient to have funding and required

regulation at one level of government and implementation at another. Further, tied grants can be used by central governments to impose regulation on the States without cooperation and consultation. This is particularly the case where the States are used simply as a 'conduit' to allow the Commonwealth to fund third parties or their activities. While, in theory, States retain the discretion to refuse tied grants from the Commonwealth, it is only in unusual circumstances that State governments will refuse large cash grants for the benefits of their citizens. History also demonstrates that where one State agrees to the federal conditions, it becomes difficult for other States to hold the line.

Where the Commonwealth decides uniform regulation is desirable across Australia in an area outside of its heads of legislative power, we submit that rather than rely upon its fiscal dominance, it ought to engage in the necessary consultation with the States to achieve referral of legislative power (see explanation of the referral power above). The use of the legislative process results in greater clarity, transparency and accountability, although referrals of power need to be accompanied by mechanisms for State input for future changes.

In addition to tied grants, the Commonwealth has also relied extensively on direct funding programs to bypass the States in areas outside of its legislative competence. However, the High Court has more recently raised questions about the Commonwealth's capacity to achieve regulatory goals through direct funding programs in the absence of legislative backing. In *Pape v Commissioner of Taxation*, the High Court held that the Commonwealth's spending power, previously thought to be co-extensive with the Parliament's power to appropriate moneys in s 81 of the Constitution, had to be sourced in the executive power, vested by s 61 of the Constitution. This meant that the Commonwealth had to point to a source of executive power in relation to each of its funding programs.

The decision in *Williams v Commonwealth* took the restrictions on Commonwealth funding further, holding that Commonwealth funding programs, unless they fell within the normal administration of government or another exception, must be supported by a legislative grant of power. In *Williams*, the Court held the federal funding of a provider of school chaplains invalid as it relied solely on appropriation legislation. In coming to this view, the Court emphasised the importance of parliamentary accountability for spending programs, many of which are used to achieve policy objectives and regulate the conduct of individuals. The Court also emphasised the capacity of such spending programs, which often operate outside the Commonwealth's spheres of legislative responsibility, to impact on the division of responsibility within the federation.

These new limits on the federal spending power require a fresh look at the mechanisms for Commonwealth spending on areas not directly within legislative power. We would argue that this is so across the board, but particularly the case in the areas of health, education and local government. To date, the federal response to the *Pape* and *Williams* decisions has been to provide legislative backing for the Commonwealth's large number of spending programs, but not a reconsideration of whether they ought to continue, or be devolved to the States.

We submit that a more rigorous review of the Commonwealth's spending programs is required, as part of a wider review of responsibilities across the federation. Within the constitutional framework, and using the mechanisms provided for within it, as outlined above, the Commonwealth must, in consultation with the States, determine in which areas:

- it ought to take sole responsibility for regulation/service delivery;
- it ought to take primary responsibility for regulation/service delivery with contribution from the States as to the form of that regulation/service delivery;
- it ought to take responsibility for providing the broad framework for regulation/service delivery, with the States/local government administering the area with discretion and flexibility around many of the details;
- the States ought to take primary responsibility for regulation/service delivery with contribution from the Commonwealth as to the form of that regulation/service delivery;
- the States ought to take sole responsibility for regulation/service delivery.

In determining this division of responsibility, we submit that the following criteria must be addressed:

- the desirability of uniformity or congruence, such as the desirability of some degree of uniformity within the primary and secondary school curriculum to ensure minimum standards are being set, and ease of movement across Australia;
- the need for central regulation of an area because of conflicting State interest, such as the regulation of the Murray-Darling river system;
- the need to ensure equal treatment, for example, in the availability and quality of health care;
- the potential for duplication in bureaucracy and the cost of such duplication, for example, in the collection of State and federal taxation (see our further submission on this aspect of federal reform, below);
- reducing inefficiencies for individuals and business working and conducting business across State borders, for example in workplace health and safety requirements for businesses with a presence in different States;
- the extent of local as against national use of the facility/service/infrastructure, for example, the need for local control over local infrastructure (for example, cross-city bridges and tunnels) but the need for federal input in national interstate infrastructure;
- differences in local conditions, including environmental, economic, social and cultural;

- differences in community expectations;
- the need for local responsiveness; and
- historical differences in approach between States.

Redrawing the lines of responsibility based on principle would lead to less chance of duplication and any attempt at blame shifting across the federation could be resolved by reference to these criteria.

To address properly problems with responsibility and accountability within the federation, reallocation of legislative responsibility must be coupled with rethinking of the fiscal responsibilities of the Commonwealth and States within the federation. By developing a clearer understanding of regulatory responsibilities across the federation, this would also clarify the responsibility of the Commonwealth and States in the funding of particular areas.

Part 2. Rethinking the States' tax-base and equalisation within the federation

In the Australian federal system, the Commonwealth raises the great bulk of revenue, far more than it requires to meet its administrative responsibilities as they arise under its legislative programs, and its funding programs. The Commonwealth returns this money to the States through tied grants (see further discussion above), but also through unconditional grants. The GST, a tax raised by the federal government, is passed to the States as untied grants. The States are reliant on Commonwealth grants for approximately 50 per cent of their revenue, although this varies between States.

Australia's high vertical fiscal imbalance can be traced back to the takeover of federal income tax by the Commonwealth during WWII, achieved through tied grants under s 96 of the Constitution, and the High Court's broad interpretation of 'excise duties', which are exclusively within the power of the Commonwealth to impose. In 1997, in *Ha v New South Wales* (1997) 189 CLR 465, the High Court struck down as unconstitutional a licensing system for tobacco retailers and wholesalers. As a result of the loss of this revenue stream, it was estimated that the States lost $5 billion. For a short period, the Commonwealth increased its taxes on tobacco, alcohol and petrol and returned these amounts to the States as untied grants, to compensate the States for their loss of revenue. In 2000, the Commonwealth introduced a 10 per cent GST that was returned to the States.

The calculation of the return of the GST is conducted by the Commonwealth Grants Commission. The revenue is returned not based on the GST raised in a particular state, but to achieve broad fiscal equalisation across the States and Territories. This means that some of the wealthier States are cross-subsidising the less-wealthy States. The formula employed by the Grants Commission has caused ongoing tension between the States, leading to a major review of the GST in 2012.

In combination with the reform of the distribution of powers across the federation, we submit that the federal fiscal arrangements are in need of significant reform. That reform must be informed by the following:

1. The current dominance of the Commonwealth over revenue-raising and the heavy reliance by the States on federal grants, both tied and untied, reduces competition between the States, reduces the capacity of the States to implement new and innovative local programs and policies, and removes the link between revenue raising and spending which provides an important accountability check. The goals of promoting competition, innovation and diversity between the States may, however, produce a 'race to the bottom' in an effort to entice individuals and businesses into the jurisdiction. Further, returning tax collection to the States also increases bureaucratic duplication and the potential for greater inefficiency.

   The re-allocation of revenue-raising power in the Australian federation must balance these competing principles. This could be achieved by reducing (although for reasons given below, not eliminating) the level of vertical fiscal imbalance that currently pertains in Australia.

   This could be achieved by returning a tax base to the States which would allow them to move away from their increased reliance on Commonwealth grants and ineffective and socially questionable taxes (such as gambling-related taxes). Areas in which this could be considered within the current constitutional arrangements (in which the States are restricted in their ability to raise sales taxes) include income and company tax.

   Another way this may be achieved is by exploring the possibility of central collection of revenue, with the States retaining the responsibility for determining the tax base and/or different tax rates. In this respect, Australia could look to Canada's tax collection agreements, through which the Canadian Provinces (State equivalents) agree to abide by the tax base set by the central government but set their own rates and credits within these limits. Tax is collected by a single agency. Such a system would have to operate within the Australian constitutional framework, but we believe it is an interesting alternative to the current arrangements worthy of consideration.

2. Social equality across the federation, in terms of equal access to minimum levels of health, education and social welfare services and infrastructure must be a goal of the Australian system. The ongoing role of the Commonwealth Grants Commission in achieving this is pivotal. As it is now, the objective in this respect ought to be focussed on achieving minimum levels of service delivery in these areas, rather than absolute fiscal equalisation across the federation. To achieve a minimum level of horizontal fiscal equalisation requires vertical fiscal imbalance and as such it is appropriate that the Commonwealth continue to collect more revenue than it requires. However, the current extent of the vertical fiscal imbalance is unnecessary, and therefore ought to be reduced in accordance with the submissions in (1), above.

3. Redistribution of revenue from the Commonwealth to the States must be in a form that allows for the achievement of the distribution of responsibilities outlined in Part 1, above. That is, where it is found appropriate for the States to have sole responsibility for regulation/service delivery but they have insufficient capacity to generate their own revenue to meet that responsibility, federal revenue ought to be returned as untied grants. Where it is found appropriate for the Commonwealth to take responsibility for providing the broad framework for regulation/service delivery, with the States/local government administering the area with discretion and flexibility around many of the details, the conditions on grants need to be drafted to reflect this.

Part 3. Reform of cooperative federalism mechanisms

The Constitution envisages that the Commonwealth and States will need to cooperate in many areas of regulation.[1] The main vehicle for cooperation is the Council of Australian Governments (COAG), which is a meeting of the Prime Minister, State Premiers, Chief Ministers of the NT and ACT and representatives of local government associations. COAG was a derivation of Premiers' meetings which occurred prior to federation, and continued in the early years of the federation. Since the 1930s, the Commonwealth and States have been meeting regularly to discuss and reach agreement on a wide range of policy areas of federal concern.

In our submission COAG is a necessary and effective vehicle to enable the Commonwealth and the States to regulate a range of issues of joint concern. It is appropriate that the peak cooperative body consist of the heads of government, being the members of the Executive with the clearest mandate to negotiate and enter agreements on behalf of the Commonwealth and States. However, in our submission, COAG currently suffers from a number of procedural defects.

1. Being a meeting of heads of government, COAG is not representative of the membership of the Commonwealth and State parliaments. The executive governments of the Commonwealth and the States enter agreements and take on obligations without the endorsement of their respective parliaments. It is right that the executive should be able to enter agreements in this way, but in our submission there should be formal procedures for Commonwealth and State parliaments and through them the public to be informed about COAG deliberations. This might include:

    a. tabling of the COAG agenda in State and Commonwealth Parliaments a week in advance of the meeting; and

    b. formal reporting requirements to State and Commonwealth Parliaments at the conclusion of meetings. This would also allow greater transparency for the public as to the activities of COAG.

[1] The Constitution makes express provision for an Interstate Commission in s 101, and most areas of Commonwealth legislative power are shared with the States.

2. As a meeting of executive governments, COAG risks being politicised to advance sectional political interests. Formalising COAG's procedures, in terms of attendance, contributions and agreement making will help lessen the risk of excessive politicisation.

3. There is a risk of federal domination of COAG due to Commonwealth control over the timing and frequency of its meetings as well as its secretariat (which is located in the Department of Prime Minister and Cabinet), and agenda. Establishing a fixed number and frequency of COAG meetings, establishing a joint secretariat and providing formal mechanisms for State, Territory and federal input into the agenda is needed to reduce the federal control and dominance of COAG. We recommend two fixed meetings a year, with the option for the Commonwealth to schedule additional meetings as required.