

The Tasmanian Devil is in Equalization's Details The Australian Dilemma – Welfare-based Federalism

Executive Summary

- Australia has constructed the world's most elaborate and comprehensive federal system of fiscal equalization grants.
- The country has a wealth of economic advantages, but its federal system has evolved into a nationalized system of state dependency that is both inefficient and expensive.
- The Australian Constitution embedded a mixed system of government combining American style federalism with British style centralism. It featured strong state powers but reserved the most lucrative tax sources to the central government.
- This imbalance grew with the introduction of national income and sales taxes.
- Compensation programs from the central government took the form of equalization grants which were eventually formalized into a complex formula containing perverse incentives for poorer states.
- States and territories on the receiving end could expand their federal endowments with policies that penalize economic growth, but could not expand them with policies that encourage it.
- Although some once dependent states eventually overcame the problem, the state of Tasmania has typified its worst effects.
- Tasmania has become increasingly dependent on Commonwealth hand-outs, less responsible for its own policy failures and future, and more focused on working the grants system than fixing its economy. Its dependence on Commonwealth revenue has increased to 67 per cent of total revenue.
- These outside transfers have allowed Tasmanian governments to install regulatory and tax regimes hostile to commerce, and both local and federal labour policies have hobbled its potential.
- The state's economic performance is consequently far below the Australian average.
- Since the rest of the country is starting to demand change, Tasmania must adopt reforms or the subsidy train will be derailed.

Australia has long been a lucky country. Rich in natural resources, it is also blessed with a responsive democracy and a young and growing population devoid of large disparities in income and opportunities. Yet while this luck continues to hold for the nation as a whole, it is starting to fray for some states, notably Tasmania.

Tasmania remains blessed with resources, but they are increasingly locked away in National Parks. While it remains a democracy, it has increasingly become dependent upon the whims of the Commonwealth. Long a poor state, it has increasingly become a provider of cheap tourism services and of bright young people to the mainland states. While not quite the Appalachia of Australia, it is on the same path and subject to the same type of jokes.

Why Tasmania's relative decline? In short, the blame rests with Australia's federal system. It has evolved into a complex national welfare system which has reduced the fiscal responsibility and rights of states. As with social welfare, the system's perverse effects are manifesting themselves most clearly in poor communities with limited opportunities, ones which confront large restructuring tasks, such as Tasmania.

The problems for Tasmania are not just that their children and jobs are leaving, but that their fellow Australians are tiring of the fiscal burden and the dependency. The larger states, representing over 80 per cent of the Australian population, have recently demanded an overhaul of the federal system. If put in place, the changes would leave Tasmania, after a suitable adjustment period, facing the brink.

What happened?

Background

The Australian federal system has evolved in predictable ways, though far differently than its original architects and managers had in mind.

The system was formed in the late 1890s and put into place with the creation of the Australian Commonwealth in 1901. From the start, it was based on a structural contradiction, which has been coined the “Washminster System.” Much influenced by the Constitution and federal system of the United States, the Australian Constitution established a similar structure. However, it also adopted a Westminster, British system of responsible government based in Canberra. This conjoint structure — Washingtonian federalism and Westminster centralism — was bound to lead to dynamic tension. Indeed, one of Australia’s most articulate founding fathers and Prime Ministers, Alfred Deakin, identified its central flaw early on. He warned that the Constitution left the States “legally free but financially bound to the chariot wheels of the central government.”¹ This has proven true in spades.

Like its U.S. counterpart, the Australian Constitution identifies in detail the respective and conjoint powers of the states and the Commonwealth, with the bulk of the powers reserved for the states. While the responsibilities of government have changed and grown since the turn of the twentieth century, the main responsibilities of governments — education, health, police, land, natural resources, and transport — remain, constitutionally at least, the powers of the states. The flaw in the Constitution was its allocation of tax powers. It originally allocated the largest tax, customs or trade duties, to the central government. Given that a main objective of the formation of the Australia Federation was the elimination of trade barriers between states and the adoption of a uniform trade stance, this allocation was imminently sensible.

The roots of equalization

It did, however, put in place from the start an imbalance between the spending and revenue-raising capacities of the central, or Commonwealth government and the states. The former had access to many more funds than it needed to carry out its constitutional responsibilities. This in turn led to the states’ becoming dependent upon the central government for funding. It also gave the central government the upper hand in determining the manner in which the funds were shared and the purposes to which they could be put.

Initially the surplus funds of the Commonwealth were reserved for struggling states, that is states that, through no fault of their own, struggled to remain solvent, political entities. One hundred years ago they regularly included Tasmania, as well as Western Australia and South Australia.

As time went on, the amount of the “surplus” declined, as the central government inevitably found more of its own uses for the funds. The states also introduced a number of their own taxes, eventually including income tax, which gave them an increased degree of fiscal independence. As a result of these trends, by the late 1920s the Australian states received only about 15 percent of their total income from the central government and this share continued to decline during the 1930s.

Things changed fundamentally and irrevocably during the 1940s, when the Commonwealth assumed income tax powers. While initially justified as a temporary war measure, it was in fact permanent. After the war, the Commonwealth effectively prevented the States from re-entering the income tax space. The Australian High Court also helped consolidate the Commonwealth’s financial domination of the states by ruling that they were prevented under the Constitution from levying indirect taxes such as a sales tax or a goods and services tax. As a result, by the end of the decade the states depended upon the central government for over 50 percent of their total revenue.

While the level of dependency declined slightly in subsequent decades as the States introduced a number of often stupid, but legal taxes, it remained far above what Australia’s founding fathers had in mind and far above the standards of other federal countries. For example, the Canadian provinces, in aggregate, depend up Ottawa for only about 15 percent of their total revenue. The imbalance between the central government and the states increased once more in 2000 with the Commonwealth’s introduction of a 10 percent GST. The proceeds went in full to the States, with the proviso that they

¹ La Nauze, *Alfred Deakin*, Melbourne University Press, 1965, p 359.

eliminate or phase out seven of their own taxes. This deal brought the states what they had long sought — access to a large growth tax. They also, however, became more dependent upon the Commonwealth for funding. Indeed, their dependency ratio is back up to its immediate post war high.

Equalization Formalized

The problem was not just in the vertical imbalance between levels of government, but in the way the Commonwealth allocates funds amongst the states.

Initially, from federation, the surplus funds were allocated on a one-off basis to struggling states. There was no attempt to equalize income or services across the states and the grants were viewed, at least by the Commonwealth, as temporary. Starting in the 1930s, the perennially struggling states, including Tasmania, demanded a more comprehensive and permanent system. They also argued that the grant system should be put at arms length from the political process and turned over to a dedicated bureaucracy. The Commonwealth and the more prosperous states naturally resisted these demands. But in the 1930s, a successful pro-independence referendum in Western Australia scared the Commonwealth into acceding to the demand, albeit in starts and spurts.

In 1932, the Commonwealth established the Commonwealth Grants Commission [CGC] to devise a methodology and provide advice on the allocation of grants amongst the States. Initially the Commission advised that, as in the past, these grants should only be provided to the poorer states, including Tasmania. However it also began subtly to alter the aim of the grants process, from being temporary to permanent, from a stop-gap measure to a built-in equalization of income and services.

These trends became more entrenched and more powerful as the years progressed and more funds were pumped through the grants system. As with the social welfare system, the 1970s were a seminal period for the Australian federalism. First the CGC effectively redefined the aim and scope of the process. Where previously the grants were allocated only to the poorer states, they were now allocated to all. Whereas in the past the grants were designed more as a top-up of overall fiscal capacity, the aim was changed to equalization of the fiscal capacity of all states.

In 1970 the Commission introduced the idea of horizontal fiscal equalisation (HFE), the aim of which is to allow all states and the two territories, the Northern Territory and the Australian Capital Territory, to provide a "standard" level of services, irrespective of the cost of providing them or their ability to pay it. This HFE was developed further in subsequent years and its scope expanded to include more services, additional revenue sources, indebtedness and capital expenditure. The Commission's deliberations, not surprisingly, became the focal point of all state treasuries. Importantly, it became a tradition of successive Australian governments to accept the recommendations of the Commission in terms of the allocation of the pool of grants unaltered. Thus, while the Commonwealth traditionally determines the quantum of the grant pools, the Commission determines the allocations of the pool. In other words, the CGC welfare approach has prevailed.

In the early 1970s, the Commonwealth introduced specific purpose or tied grants, under which the states which were provided with additional funds, but only for specific purposes. Tied grants have grown significantly over the last three decades and now make up just under one half of all funds paid to the states by the Commonwealth. While tied grants were potentially a means of overriding the equalization process, in reality they have not done so. Starting in the early 1980s, the CGC changed its methodology to prevent this from happening by simply including tied grants in calculations of revenue-raising capacity and thereby using general purpose grants to equalize the differences in tied grants. Perversely, despite the Commission's effective override, tied grants have continued to flourish, along with the army of federal bureaucrats and interstate committees that claim to manage them.

From its inception, the equalization process was criticised for its potential to create dependency amongst the states, as well as the potential for gaming and other unproductive activity. In fairness, the CGC went to great lengths to limit these distortions. To avoid dependency, the Commission's methodology judged the states' fiscal needs not on what they did, but rather on what they could do if they applied a standard level of service or taxing effort. As a result, if a state chose to apply below-standard tax rates, it would not be compensated for this choice in the form of higher grants. However, if a state chose to provide an above-standard level of service, it would receive compensation for its more generous policy position.

To avoid gaming, the Commission involved all the states and the Commonwealth in the determination of methodology and data generation, and created a competitive and countervailing process of debate and

scrutiny. In other words, attempts by one state to rig the system in its favour would be picked up and resisted by others. It also subjected the process to frequent review by independent expert parties. The Commission tried to rely as much as possible on published data and put great effort into determining the format of, and verifying the quality of, data provided by the states. Despite the Commission efforts, which were formidable, dependencies have resulted and gaming and unproductive behaviour are common. Indeed they were inevitable. The task of simulating something as complex and malleable as a "standard level of service" in an independent and objective manner across such a large continent nation is simply impossible. The Commission process also contained a number of central flaws that aggravated the growth of dependency.

First, the Commission process, by trying to be policy-neutral, gave no consideration to the effect of state decisions on its prospects for expansion. In short, the process is dynamically neutral. For example, if a state such as Tasmania locked away large chunks of its mineral wealth, it was not only not penalized but received compensation for its revenue-raising disadvantage. If a state such as Tasmania imposed higher taxes and regulations that created a disincentive for job creation and economic growth, it suffered no penalty. If a state, again such as Tasmania, undermined competition and interstate trade through local preference in government procurement, it received no penalty. If a State, such as Tasmania, borrowed heavily to fund unproductive job creation programs through government-owned businesses, it often received additional compensation for higher debt levels and no penalty for the waste of funds.

Second, the Commission failed to consider differences in efficiency of service provision. The standard used for benchmarking state needs has inevitably been determined by the policies of the largest states or the majority of states. Seldom were independent measures of relative efficiency undertaken. As a result, the system encouraged the adoption of a standard approach across all states, not based on effectiveness or efficiency, but rather on already accepted policy. Indeed, the system has in effect not treated efficiency and effectiveness as policy goals, but rather as something to be treated neutrally.

Third, the Commission failed to take into consideration the difference in economic structures of each state. For example, its standard tax policies were often based on those set for Sydney, a wealthy metropolis with high wages and high costs. These policies were completely inappropriate for a rural-based state like Tasmania, with a low cost of living and wages.

Four, the Commission, as unrestrained bureaucracies are wont to do, has gone to extreme lengths to equalize income and expenditure. It now even includes the provision of public golf courses and tries to determine a standard level of golf course services across the continent, as well as the advantages and disadvantages each state and territory has in providing these services. This has resulted not only in excessive costs and an impossibly complex system, but provides plentiful scope for gaming and perverse trade-offs.

In summary, the equalization process as developed in Australia has over the last thirty years in effect equalized income across all the states — as if the country were a centralized nation. As such, it undermines the intent and detail of the Constitution.

The Tasmanian problem

It has also had perverse effects on some poor states, including Tasmania. Over the last two decades in particular, Tasmania's economic performance has consistently been inferior to that achieved in the rest of Australia.

This shortfall has been significant and across the board, including economic output, productivity, investment, job creation, labour participation, unemployment and wage growth. During that time Tasmania's economy grew at one-third the rate of the rest of the country. This in turn was driven by low and declining levels of productivity, rates of investment at half the level of other states, low levels of new business formation, low and often declining population levels and an economy increasingly dependent upon government spending and subsidies. The poor economy and job prospects have encouraged increasing numbers of Tasmanians to leave the State, particularly the young and educated. As a result, Tasmania has the oldest average age population, the lowest work force participation rate and a shortage of skilled people. Tasmania has also failed to attract many overseas and interstate migrants to compensate for the loss of locals.

Why the decline? Official reports on the Tasmanian problem, of which there are many, tend to blame natural causes such as the state's small size and remote location. While these play a role, they are in

the end minor factors. A recent study, undertaken by the NZ Business Roundtable seeking lessons for its own economy and ACIL Economics, has been more forthright and detailed. It diagnosed three main causes, all of which are driven to a large extent by the grants system.

First, the Tasmanian and Commonwealth governments have created an environment that is unattractive to business. State regulation has stifled business innovation and prevented competition. State taxation has been high and it targets the business sector. State government debt levels are high and have been accumulated for largely unproductive purposes. The government has had a long history of bailing out failing firms and subsidizing others, even in dying industries such as textiles. The government has developed a reputation for being opposed to development, regardless of how well environmental impacts are managed. For example, the rights to object to developments are more generous than in other states.

A prime example is the Tasmanian government's recent ban on the growing of genetically modified crops. Tasmania has a large agricultural sector, whose largest and most important crop is opium for the medical market. While GM poppies are not yet available, it is widely recognized in the industry that GM will be the way of the future. If Tasmania is to retain its position as one of the world's largest growers and exporters of opium, then it must accept these changes. Despite this reality, the government succumbed to a small but vocal group of organic growers and "alternative lifestyle seekers" who take refuge in subsidized Tasmania. It placed a ban on the commercial growing of the all GM crops.

The Commonwealth has played a major role in Tasmania's poor economic performance and policy. It has been instrumental in locking away vast tracts of the state's forest, as well as banning world-class paper mills. For decades it imposed a uniform wage system across the country, and forced Tasmanian businesses to pay wages on a par with those of Sydney, where the cost of living is 50 percent higher. Also the Commonwealth's high tariff policy protected manufacturing, largely in Victoria and New South Wales, and thereby imposed a high cost on Tasmanian businesses. In recent years the Commonwealth has thankfully abandoned its fixation on wage policy and liberalized it to allow much more enterprise-based bargaining. Unfortunately, the Tasmanian government undermined the Commonwealth reform a great deal with more restrictive labour laws of its own. The Commonwealth has also all but abandoned its high-tariff policies. While this change is having positive effects in other states, Tasmania is missing out, with limited growth in new manufacturing investment.

The current Labour government of Tasmania has made some reforms. It has reduced debt levels and the relative severity of its own taxes. It has resisted the closure of additional forest reserves. Nonetheless, much remains to be done to improve the business climate. Most pointedly, the current government and its predecessors have been at best slow, and more often have failed at all, to put in place the economic reform agenda that has been underway for decades in the rest of the country. Why?

Perverse Incentives

ACIL Economics blames the federal system in large part, but not exclusively

A specific, bottom-line conclusion is that Tasmanians are getting, courtesy of the Commonwealth, substantial direct and indirect income transfers that are not dependent on the state's performing well economically. It is quite the contrary: the worse the state performs, the more these mandated transfers will tend to increase. This tends to insulate Tasmanians' living standards to a significant degree from the full impact of poor economic performance. In turn, this means that the electorate is likely to be less concerned about the contribution of poor institutional design and poor policy choices.

This judgement is certainly supported by the evidence. Over the last two decades, because of the State's relatively poor economic performance, much of which was self-inflicted, Tasmania's per capita share of equalization expanded from 147 per cent to 187 per cent of the all-state average. During the same period, its dependence on Commonwealth revenue increased to 67 per cent of total revenue. Put another way, for every dollar paid in Commonwealth tax, Tasmanians received back \$1.70 in the form of grants. In short, Tasmania has become increasingly dependent on Commonwealth hand-outs, less responsible for its own policy failures and future, and more focused on working the grants system than fixing its economy.

The federal system also put in place large political barriers to change. First, the system lacks transparency, and as a result people are unaware of their level of dependence. Second, under the system it is rational for the electorate to choose not to undertake reforms that might ensure a more robust economy. They expect that others will compensate them for slower economic growth, and in any

case their kids can go elsewhere for jobs. Third, the system tends to attract people to Tasmania who prefer dependency. The state is attracting substantial numbers of the unemployed, pensioners and those attracted to alternative lifestyles. They are not directly interested in achieving a robust economy and are happy to live on government hand-outs and enjoy Tasmania's relative low-cost housing.

Conclusion

The problems for Tasmania are twofold. First, the federal system offers a false hope. While the system continues it will compensate for bad policies, but not fully. While it does try to equalize capacity across the country, it does so using data that is up to five years old. The compensation does not therefore keep up with demand or declining living standards. Moreover, once a State gets a reputation as backward and anti-business, the process tends to accumulate, as do its social and cultural side effects.

Second, the system is not sustainable, economically or politically. As a result of the rapid relative progress achieved by Western Australia and Queensland, in a few years the majority of states — representing over 90 per cent of the national population) — will be net contributors to the federal welfare system. There is already a move by the wealthier states to change the system. When Queensland joins them, as it will, the game will be up and Tasmania will be badly exposed.

In summary, Australia has constructed the world's most elaborate and comprehensive federal system of fiscal equalization grants. In so doing, it was fully aware of the risks and put great effort into minimizing them. Nonetheless, as shown by the case study of Tasmania, it has failed. The system has sheltered Tasmanians from taking responsibility for their own future and induced them to be dependent on the generosity of their fellow Australians. This has bred a culture of complacency and political resistance to change.

The problem for Tasmania is that the system has pushed the generosity of fellow citizens beyond their limits and change is on the cards. It will be a tough time for Tasmania.

About the Author:

Mike Nahan is the Executive Director of the Institute for Public Affairs, an independent think tank based in Melbourne, Australia. He is an experienced commentator on resource economics, economic development, State finances and inter-governmental relations. Born in Ann Arbor, Michigan, Mike Nahan attended the University of Michigan where he graduated with a degree in Economics. Although, after coming to Australia in 1978, he went on to complete a Ph.D. in Economics at the Australian National University, along the way he managed to fit in a degree in Zoology, giving him a breadth of knowledge that many economists lack. That breadth was enhanced by the experience of owning and running a small trucking company in the United States, five years working and traveling in Asia and, later, working for the Western Australian Ministry of Economic Development as Director of Policy. Mike Nahan joined the IPA as Director of the States' Policy Unit in 1990 and became Executive Director in September 1995.

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