5. The reform imperative and Commonwealth–state relations¹

The Hon John Brumby MP, Treasurer of Victoria²

More than 40 years ago, the late Donald Horne coined one of the most memorable phrases to describe our nation. He called Australia the ‘lucky country’. As many of you no doubt realise, Horne was not singing Australia’s praises. Rather, he was decrying Australia’s complacency, its lack of innovation in important forms of industry and business and its failure to match the enterprise of other prosperous industrial societies. Horne believed that Australia owed its prosperity not to its native creativity and innovation, but rather to blind luck.

Horne warned that we were a nation taking it easy, that we were coasting along and drifting with the tide. While I don’t agree with everything Horne argues in *The Lucky Country*, I do believe his message is as apt today as it was in 1964. Most importantly—as Horne cautioned 40 years ago—we need to remain focused on national reform and innovation if we are to prosper in the twenty-first century. While Australia’s economic performance has been solid through the mid 1990s and in this decade, our productivity growth has stalled and our living standards are slipping in relation to comparable OECD countries. And, as I will address in some detail here, the challenges we face are not just economic.

In the health area, for example, the paradigm has changed dramatically. For the first time in our history, the impact of non-communicable diseases now exceeds that of communicable diseases. Yet our health system remains largely designed to treat injury and infections.

New solutions, new reforms and a recommitment to cooperative federalism are crucial to meeting the challenges facing our country.

The reform challenge

I want to talk here about how cooperative Commonwealth–state relations will be crucial in meeting the reform challenges ahead. In particular:

- human capital (the National Reform Agenda)
- regulation (the National Reform Agenda)
- innovation (the National Innovation Agenda)
- climate change and water
- Commonwealth–state financial relations.

The need for action

As I have mentioned, our productivity growth is stalled, the gains from past reforms are running out and we risk relying on blind luck yet again. Australia's first wave of reforms introduced by the Hawke Government in the mid 1980s saw the floating of the dollar, the deregulation of financial markets and the beginning of a phasing out of tariff barriers designed to protect Australian industry.

These reforms lowered the cost of imports as inputs into Australian industry, made exports more competitive and generally allowed the Australian economy to begin the process of aligning with the global economy.

Under the leadership of the Keating Government, the introduction of enterprise bargaining and the 1995 COAG agreement to implement a National Competition Policy (NCP) were central to a second wave of reform that sought to increase competition and productivity.

These measures were pivotal in boosting the competitiveness and growth of the Australian economy. The NCP was groundbreaking in the sense that all governments agreed to a common set of objectives, and it demonstrated what could happen when Commonwealth, state and territory governments had a common purpose and collaborated to implement major reforms.

Australia's current economic success owes as much to past reform efforts as it does to the resources boom. In the case of Victoria, for example, our leadership in implementing the NCP as well as other micro-reforms has meant our economic performance is much stronger than it otherwise would be. In fact, Access Economics in its most recent *Business Outlook* described Victoria's performance as 'magnificent' despite 'the onslaught of the \$A, interest rates and drought'.

To ensure our prosperity in the future, Australians must take the next step in reforming our economy, and cooperative federalism—governments working together—is the best way to achieve these reforms.

Evolving federalism

Australia's federal system has both strength and weaknesses. To engender a more cooperative federalism, we need an overhaul of Commonwealth–state relations; and, as someone who has served in state and federal parliaments, I feel better qualified than many to draw that conclusion. I've seen Commonwealth–state relations from just about every angle: as a federal MP in the 1980s during the Hawke Government, as chief of staff to a cabinet minister in the early years of the Keating Government, as Leader of the Victorian Opposition for six years during the Kennett Government and as Victoria's forty-ninth Treasurer for the past seven years.

There's not much I haven't seen, heard or experienced about the often very volatile relationship between the Commonwealth, states and territories.

The causes of many of the problems in Commonwealth–state relations today stem from the fractious relations that existed between the states that voted for Federation in 1901 and the flaws in the constitution that they accepted as an article of federal union. More than a century later, we are lumbered with constitutional machinery that was intended to protect each state's prerogatives from each other and from the Commonwealth Government. This machinery has frequently made the pursuit of national reform a difficult and complicated endeavour.

Prior to federation, Australia's states maintained fierce tribal rivalries with one another. They levied customs excises on goods passing between their borders. They laid rail track with different gauges. Victoria even celebrated the date of its separation from the colony of New South Wales for nearly 50 years, prior to Federation. Not surprisingly, the founding fathers of Australia's constitution were concerned to protect state power and they anticipated the federation would function by allocating different responsibilities to the Commonwealth and the state governments so that each could act autonomously within their respective spheres of influence. However, despite these intentions, Australia has evolved rapidly into what has been termed a system of 'cooperative federalism', where the states and a federal government share responsibility for many areas of government and must cooperate to carry out these responsibilities.

The seeds of cooperative federalism were sown in the constitution itself. Section 51 of the constitution, which outlines the Commonwealth's powers, has always been defined expansively by the High Court, allowing the Commonwealth to assume powers that are implied or incidental to those powers. Section 96 of the constitution further enables the Commonwealth to make payments to the states on whatever conditions it determines. This has become the principal means by which the Commonwealth has influenced or mandated policy in what have traditionally been seen as state responsibilities.

Alfred Deakin was very prescient when he wrote, back in 1902, that the constitution had made the states 'legally free, but financially bound to the chariot wheels of the Central Government'.

Vertical fiscal imbalance

The extreme degree of fiscal imbalance in the Australian federal system leads to the need for substantial financial transfers from Canberra to the states. And Canberra cannot resist the temptation to control how these funds are spent. This undermines one of federalism's key strengths, by narrowing the scope for policy experimentation and innovation and restricting the capacity of states to respond to local needs and preferences. The current Federal Government has repeatedly

used its control of the purse strings to impose ill-considered, ideologically driven compliance measures on the states' delivery of core services, such as education and health. These measures are typically focused on micro-managing the way states deliver core services, rather than on the big-picture outcomes that we are all striving to achieve.

As a result of vertical fiscal imbalance, and for many other reasons, a joint Commonwealth–state approach is important. I'd like now to turn to what it will be important for now and in the near future.

National Reform Agenda

Victoria has led the push for a new round of economic reform, by putting forward the National Reform Initiative in August 2005—a third wave of reform to ensure Australia's future prosperity. This culminated in the National Reform Agenda (NRA), agreed at COAG.

There are two broad dimensions to this new NRA. The first aims to improve the economic environment through further competition and regulatory reforms. The second and most important element of the reform agenda concerns human capital. Together, these reforms will increase our standard of living through raising economic productivity and workforce participation.

And the gains are significant: the Victorian Treasury has estimated that the potential impact of the NRA on GDP will be up to 5 per cent over the next 10 years and 14 per cent over the next 25 years. After 10 years, this translates to a fiscal dividend to the Commonwealth of up to \$10 billion, with less than \$3 billion shared between the states. After 25 years, this translates to a fiscal dividend to the Commonwealth of up to \$35 billion, with less than \$5 billion shared between the states. Even after one allows for the transfer of GST revenue from the Commonwealth, the states receive only 28 per cent of the total tax revenue in Australia, yet are responsible for the lion's share of service delivery. It is imperative to redistribute these fiscal dividends fairly to ensure that vertical fiscal imbalance is not further exacerbated and the states can afford real reform.

Reforms in human capital, or workforce incentives, education and health, are the areas that will produce the biggest economic gain and greatest benefits through participation and productivity. Skills and education have never been more important. We need to ensure that we are engaging people in learning throughout their lives to enable and motivate them to participate in the workforce more efficiently and for longer. And, of course, good health provides the foundation for economic and social participation.

Health

I mentioned in my introductory comments the new health paradigm. In the old days, people used to die from injury or infection, and we built whole health

systems aimed at treating injury and infections, especially evident in our investment in drugs and acute-care hospitals. But now, the developed world has undergone an epidemiological transition. Now it is non-communicable or chronic disease that will kill most people; in fact, chronic disease now accounts for more than 80 per cent of mortality in Western countries and is rapidly encroaching on communicable disease as a major cause of illness and disability in the developing world also. By chronic disease, I mean diabetes, heart disease, hypertension and other health conditions directly related to the more affluent, inactive lifestyles of industrialised countries. In the twentieth century, we made rapid advances in longevity and health on the back of three fundamental health innovations: clean water, immunisation and antibiotics. Together they have saved millions of people from the scourge of waterborne infectious diseases, common infectious diseases like small pox, measles and polio and bacterial infections like tonsillitis and blood poisoning. In a sense, each one has been a magic bullet that has delivered better health for whole populations.

Today we don't have a box of magic bullets at our disposal. Paradoxically, our ill health is largely the result of social, economic and technological success; the 'epidemiological transition' has occurred as a direct result of social, economic and medical progress. Let me put more of this in a practical context. The Department of Human Services has estimated that more than \$1 billion of income is lost by twenty-five to sixty-four-year-old Victorians per annum due to poor health associated with smoking, obesity and high blood pressure. This illustrates the enormous benefits of focusing on prevention. It's a simple concept: healthier people equal a more capable workforce—capable of participating in the workforce and capable of being productive by using the skills they have gained. However, estimates of the economic cost of poor health usually encompass only the financial costs of providing health care and the years of life that might be lost. Costs that are less often considered include lost employment and productivity resulting from poor health, but these are significant.

For example, new research from the Victorian Department of Treasury indicates the presence of Types 1 and 2 diabetes in females aged twenty to sixty reduces the probability of employment by about 12 per cent. The productivity effects of poor mental health are even more pronounced. For example, a female with a mild level of psychological distress is about 7.6 per cent less likely to be able to hold down a job as her healthy counterpart. A male with high levels of psychological distress is 36 per cent less likely to be able to do the same. To put this in context, a mild level of psychological distress might mean feeling tired, nervous, hopeless, fidgety and sad 'most of the time'. A high level of psychological distress might mean having these feelings 'all of the time'.

The economic cost of poor health is a real one—and, of course, the flip side is that good health provides the foundation for economic and social participation.

To address this issue, we need a national approach to shift the focus of our health system towards prevention rather than treatment, to reduce chronic disease and achieve a healthier workforce. We need a fair share of the fiscal dividends the Commonwealth is set to reap from the National Reform Agenda so that we can boost our investment in preventative care.

National Innovation Agenda

While it is imperative that we improve our health, education and training outcomes, this alone will not be enough to safeguard Australia's prosperity and productivity in the new century. The OECD estimates that in advanced industrial economies, innovation and the exploitation of scientific discoveries and new technologies have accounted for 50 per cent of economic growth. This is a fact recognised by global powerhouses such as the United States, which in 2006 released its American Competitiveness Initiative—a 10-year US\$137 billion blueprint for investment in research and development capacity, skills and training.

This would be equivalent to the Australian Government providing about \$860 million a year in additional investment in science and technology research and development. While Australia has no shortage of innovative and creative people, it lacks a cohesive and focused nationwide system to best translate their work into tangible economic gains.

Recently, the Australian Innovation Research Centre provided compelling evidence, if we needed it, that the lucky country's luck had just about run out. In a sobering assessment, the centre cautioned:

Australian industry is no more innovative than it was a quarter of a century ago. We don't export a higher proportion of high-value goods, the proportion of our stock market comprised of [sic] technology companies hasn't grown, our companies introduce fewer new products and services than those of other countries, and our industries have significantly lower ratios of research and development to sales than comparable economies.

The NRA needs buttressing. This is why the Victorian Government will soon release a National Innovation Agenda (NIA), which will build on and extend the NRA.

Our vision for an NIA encompasses five critical areas:

- increasing incentives for business innovation
- building new innovation infrastructure
- developing new skills for the innovation economy
- creating a better regulatory environment for innovation
- forging better connections and collaborations.

The NIA will ensure that additional value, jobs and wealth are created from the NRA, as well as delivering significant economic and social returns in its own right.

The National Reform Agenda

The NRA reforms will help to ensure that we have a labour force with the skills business needs to innovate, even as population ageing and lower fertility rates place pressure on the labour force and the growth of highly skilled industries creates growing demand for skills.

Competition and regulation reforms will help to create a competitive regulatory environment—one that promotes the competitive pressures that drive innovation, and does not impede business as it responds to those challenges.

In this context, an NIA would complement and follow on from the NRA, encouraging business to be more innovative and to take advantage of human capital and competition and regulatory reform currently being pursued. So, for example, new innovation infrastructure should include a clear national plan for building the information and communications technology (ICT) infrastructure that is required to participate effectively in international business and research. The importance of such reform is illustrated by the evidence of Australia's high take-up of ICT equipment and the impact that take-up has had on the broader economy.

GST distribution

Our current Commonwealth–state financial relations impede progress on these vital challenges. I have already spoken about our extraordinary vertical fiscal imbalance (VFI). Additional problems are generated by our problems of horizontal fiscal equalisation (HFE).

In 2006–07, Victoria will receive only 87 cents of every dollar that Victorians pay in GST. Victorians pay about \$1.24 billion more in GST than we receive (we pay \$9.75 billion in GST and receive \$8.51 billion back in General Purpose Payments). We subsidise other states by \$242 a person.

Despite the emergence of a 'dual economy' in Australia, where Western Australia and Queensland are benefiting from high growth rates and booming mining royalty revenues, New South Wales and Victoria are still carrying most of the burden of HFE, with Queensland still a net beneficiary from HFE.

Now, the rationale for the redistribution of GST funding to the states becomes more arcane with the passing of the years. The assessment methodology for the redistribution comprises individual consideration of about 40 main expenditure categories, 13 revenue categories, as well as about 30 Specific Purpose Payment (SPP) categories. Then a further 350 expenditure component assessments and about 40 revenue component assessments are applied.

GST 'black box'

Without delving further into this 'black box', I'll simply point out that the redistribution system intrinsically acts as a disincentive for states to undertake reforms encouraging economic growth. Rather than seeing strong fiscal incentives for promoting development and growth, states operate in an environment in which direct revenue gains from public policy reforms are to a considerable extent 'equalised away' by the current HFE arrangements because revenue capacity growth is a key factor in assessments. There is a growing view among businesspeople, opinion leaders and the general community that we need fundamental reform of HFE in Australia. Victoria concurs and we are keen to open up dialogue with the Commonwealth and other states to find a better, simpler and more equitable way to distribute GST revenues.

Victoria supports the principle of equalisation and redistribution to those states with small economies, however, resource-rich states with substantial financial capacity, such as Queensland and Western Australia, should at a minimum be able to stand on their own, and potentially help those states in clear need of assistance.

Any reform model should be a simple and implementable approach that addresses the significant deficiencies of the current system, while retaining the core concept of horizontal fiscal equalisation based on the smaller states and territories continuing to get the support they need from the larger and stronger states.

To achieve this, Victoria proposes that more substantial HFE reform should be built around four pillars:

- protecting the fiscal positions of the smaller states and territories
- delivering greater certainty of GST revenues for all states in the medium to long term
- reducing the distortions and deadweight costs imposed by the current system
- managing the transition to the new model.

We are keen to open a dialogue, with the Commonwealth as an active partner, to find a better and simpler way to distribute GST revenues in order to provide greater funding certainty and remove the disincentive for states to pursue economic reform. We recognise that no model is likely to please everyone. But we know that without these or similar reforms, Australia's capacity to undertake the NRA and NIA and address our key challenges in developing our human capital, our competition and regulatory policy will be jeopardised. Doing nothing about HFE is simply no longer an option.

Today I can say that Victoria will be advocating a new model in the very near future.

Our environmental challenges

The other major challenges we face as a federation are environmental: water and climate change.

Climate change

In February 2007, the International Panel on Climate Change issued a report that said the scientific evidence was now ‘unequivocal’ that global warming was upon us and that the pace of climate change was due to human activity. While there will always be debate about the extent and rate of climate change, the reality is we must begin to act now to protect the environment and to provide a degree of certainty for industry in a carbon-constrained world.

The Victorian Government has long recognised the need for action on climate change. We have invested \$1.8 billion in our Innovation Agenda since 1999, allocated \$103.5 million for clean-coal technologies (through the Energy Technology Innovation Strategy), invested \$30 million in the Centre for Energy and Greenhouse Technologies, contributed \$50 million to building the world’s largest solar power station of its kind in Victoria and instituted the Victorian Renewable Energy Target (which mandates 10 per cent renewable energy by 2016). In a number of these areas (clean coal and solar power), we have been able to work very constructively with the Federal Government.

As another initiative, the government is supporting the development of a bio-fuel industry and aims to manufacture more than 400 litres of ethanol or bio-diesel by 2010 with significant environmental benefits. Our aim is that by 2010, 5 per cent of all transport fuel will come from a bio source, leading to improved air quality in metropolitan areas and significant regional investment in country Victoria.

But it has long been clear that we also need a clear carbon price signal to bring forward commercial investment in clean-energy technologies. Only when firms and households face a clear price signal will the incentives be there to adopt more energy-efficient, less greenhouse-intensive technologies.

Uncertainty about greenhouse policy, and the lack of a clear price signal, is now becoming a significant impediment to needed new base-load investment in long-lived electricity generation assets. This was clearly brought out in discussion papers released in November 2006 by the COAG-commissioned Energy Reform Implementation Group, based on extensive stakeholder consultation within the energy sector. Our need for energy security alone tells us that we cannot allow this degree of investment uncertainty to persist.

We have been strong proponents of a national emissions trading scheme to send a clear price signal to energy producers and consumers and reward businesses that adopt less carbon-intensive technologies. While all greenhouse abatement

options entail costs for energy consumers, it is becoming increasingly clear that the costs of inaction are likely to outweigh the cost of mitigation. And an emissions trading scheme is the most effective means of abatement because it provides real financial incentives for firms to reduce their emissions but leaves it up to the market to implement the lowest-cost form of abatement. The flexibility of permit trading means that the impacts on business and consumers can be minimised. A domestic scheme can also be designed in such a way to protect adversely affected companies and groups, and link in with international schemes.

Leaders of major corporations and businesses in critical energy industries are now breaking ranks with the Federal Government and calling for Australia's involvement in carbon emissions trading schemes. Recently, some of Australia's largest companies, including from the energy, resources and manufacturing sectors, have submitted their views to a state and territory task force examining a possible design for a national emissions trading scheme. Major companies such as BHP, Rio Tinto, Shell and Insurance Australia Group have joined calls for the implementation of an emissions trading scheme. Rio Tinto suggested that the lack of a global mechanism should not be used as an excuse for inaction on the domestic front.

Australia urgently needs national policy leadership on this vital issue; we cannot wait until the rest of the world solves the problem or it will be too late. The states and territories have done the groundwork in developing a workable design for a domestic national emissions trading scheme.

Key elements of the state and territory proposal are:

- the scheme will be a national 'cap-and-trade' scheme initially covering the stationary energy sector
- to provide certainty, investors will always have 10 years of firm caps, with a range of caps for the following 10 years; the range of caps for the second 10-year period provides the flexibility to respond to any changes in Australia's international obligations or circumstances
- it will have modest initial emission reduction targets (to be agreed) to allow a gradual transition for the economy
- assistance will be provided to adversely affected generators and energy-intensive trade-exposed industries (most likely through a free allocation of permits)
- the scheme will be able to be linked to international schemes in the future.

Now it is time for Canberra to accept the states' longstanding offer to join them in implementing a scheme as soon as practicable. I hope the Prime Minister's Task Group on Emissions Trading seriously considers the benefits of an early

domestic scheme to prepare Australia for a future carbon-constrained world, when it releases its discussion paper.

Water

To take another example, let's take the currently very topical issue of water management—one of Australia's most significant national challenges.

If you believed the Prime Minister, you'd think the states had been doing nothing to reform our water management framework or to protect our water assets. This is far from the truth.

Victoria has been leading the nation on water reform for 20 years. In the past couple of years, we unveiled our blueprint for securing Victoria's water future for the next 50 years, *Our Water Our Future*, which led to a more sustainable balance between consumption and environmental uses of available water supplies, a more robust system of water property rights and a more dynamic and efficient water market than anywhere else in Australia.

Ultimately, however, it is likely to be beyond the efforts of any state acting alone to resolve future water supply and demand imbalances in the most cost-effective way. The Commonwealth has called for a transfer of powers over the Murray-Darling Basin in order to accelerate the pace of water reform. Yet Canberra's record on water management does not stack up too favourably. In *The Age* newspaper in February 2007, Andrew Macintosh described the Federal Government's \$10 billion water plan as 'a bad remake of Groundhog Day, only without the happy ending'. Macintosh notes that the Commonwealth 'has made too many similar announcements in the past for it to be credible that this one will solve the nation's water problems'. In the past 10 years, no fewer than 12 such announcements have been made by the Commonwealth. None of them has 'solved our water woes or even put our rivers on the path to restoration'. Nor is there much real evidence of 'reform' in what the Commonwealth is proposing.

Our national vision should be for a secure set of diversion limits to ensure a sustainable level of environmental flows and the allocation of all non-environmental water through water markets. This calls for a water grid of interconnected systems within South-East Australia facilitating the broadest practicable basis of trade in water entitlements. Only in this way can we ultimately secure a sustainable and efficient allocation between agricultural, industrial, residential and environmental uses.

Let me be clear. Victoria will support a plan that acts in the national interest to protect and preserve our most precious resource. Securing our water resources for the future is one of the biggest challenges Australia has ever faced. The best way to meet that challenge is to come up with new solutions:

- that are properly thought out

- that are developed in consultation with the community, industry experts and relevant government departments
- that are properly costed
- that do not raise more questions than they answer
- that cannot be addressed by the Prime Minister issuing a media release announcing his plan and then following that up a few days later with a letter to the leaders of each state and territory.

This is unacceptable—unacceptable because you can't unwind 100 years of constitutional control of the river system with a media release and a letter. That is why the Victorian Premier, Steve Bracks, has set three preconditions regarding John Howard's plan for the Murray-Darling:

- Victorian farmers and irrigators are not disadvantaged
- we want assurances from the Prime Minister and Malcolm Turnbull that this is not privatisation of our water resources by stealth
- we want to see the existing federal \$1.8 billion fund for water projects actually flowing into projects that have been waiting for months for Canberra's approval.

Premier Bracks, together with the other premiers, is attending a meeting called by the Prime Minister to discuss the \$10 billion water package. Victoria had already asked for such a meeting. We now go to that table wanting to see details of the Prime Minister's proposal, because—as far as I can see—there are no details. Indeed, key federal departments including Treasury, finance and the environment were left out of the process of formulating the package—unorthodox at best; arrogant at worst.

I can tell you that our officials have examined the Prime Minister's proposal. And they have raised more than 40 significant issues that need to be resolved. Steve Bracks has today written to the Prime Minister outlining those issues. Issues around:

- the scope of the proposed arrangements
- the time line
- governance
- funding
- river operations
- water entitlements and trading
- flood-plain management
- water-quality management
- land-use planning
- urban water supply within the basin
- irrigators' existing property rights
- metering and monitoring

- implications for the Murray-Darling Basin Agreement
- any other further work.

These are serious considerations.

We are not talking about a modest medium-term state-based water-saving project. The Prime Minister has proposed a \$10 billion plan that dramatically reshapes federal–state responsibilities. So how will that work?

Tell us about the funding model proposed for water reform and infrastructure projects.

How will flows from the Snowy Hydro Scheme be accounted for and managed?

Will the National Water Commission have an ongoing role?

What is the process for determining the level of environmental flows?

And how do we find a balance between these and the entitlements of irrigators?

Does the Commonwealth propose to manage urban water supply in urban centres around the basin.

Will the Commonwealth claw back flood-plain harvesting activities in the Darling and other catchments?

The Victorian Government has been working hard for years putting in place the right plans and projects to secure the state’s water resources for the future. We understand there is more to be done. We also understand Victoria is not facing this challenge in isolation.

Conclusion

I began by suggesting that while reform of Commonwealth–state relations might not appear to be an exciting subject for discussion, it is absolutely crucial to national economic and social planning for the next generation and beyond.

While Australia is adequately served by its constitutional arrangements that are now more than 100 years old, we must recognise that we have failed to achieve the right balance of shared responsibility and fiscal discretion between our state and federal governments.

In addition, we must heed Donald Horne’s nearly 50-year-old call to action, to realise that the days of the lucky country are well and truly numbered and that substantive action is required if we are to become the clever country, or the innovative country, or the prosperous country.

For this to occur, a joint approach between the Commonwealth and the state governments is crucial to laying the groundwork for our future prosperity—implementing the National Reform Agenda and the National Innovation Agenda and meeting out water and climate change challenges.

ENDNOTES

¹ This essay was originally presented as an ANZSOG Public Lecture on 6 February 2007.

² John Brumby assumed the office of Premier of Victoria on 30 June 2007, after the resignation of Steve Bracks.