

THE AUSTRALIAN

COAG: more pressure needed to force reforms to tax regime

HENRY ERGAS THE AUSTRALIAN APRIL 4, 2016 12:00AM

The premiers had a choice. They could simply demand more money, knowing that, with an election looming, Malcolm Turnbull would be hard pressed to refuse; or they could take responsibility for raising the revenues they claim they need and accept that voters would then hold them to account for the taxes they impose. That they chose as they did is no less disappointing for being utterly predictable.

All that, however, is water under the bridge; at this point, the only question is how the government deals with the mess COAG leaves behind.

At the heart of that mess are the cuts Tony Abbott and Joe Hockey made in their first budget to Labor's funding commitments for schools and hospitals. Labor's promises bore no relation to fiscal realities; but as I wrote in these pages the morning after the 2014 budget was released, that didn't mean just walking away from them was a sustainable strategy.

On the contrary, unless a credible alternative was put in place, the cuts were likely to cause a "political firestorm" as the next election approached, "setting up a massive conflict with the states and aggravating the Coalition's vulnerability just where it is weakest: health and education".

Unfortunately, that alternative never materialised. Consumed by other priorities, the Abbott government didn't develop a policy for funding schools and hospitals over the longer term. Labor's promises were therefore free to acquire a life of their own, mutating — as fairy dust does in this country — from a fantasy into an entitlement. With Labor now claiming that higher cigarette taxes will fully fund the Gonski package, Turnbull is left scratching for options.

In theory, the government could implement the reform it had proposed unilaterally, reducing grants to the states while making room for them to impose income taxes. The kiss of dearth would do the states a world of good; so would being forced to fund, and transparently justify to their electorates, ever-rising public expenditure. Best of all, instead of the commonwealth paying for their sweetheart deals with the public sector unions, Jay Weatherill, Anna Palaszczuk and Daniel Andrews would have to convince voters to bear the costs.

Nor are the complexities involved in devising and implementing state income taxes anywhere near as great as has been claimed. There is, after all, plenty of international

experience to go on: not only are sub-national income taxes common in federal systems but they are also widely used in unitary jurisdictions, with Sweden and Finland, for example, relying mainly on income taxes set by local governments to fund the education and health services those levels of government largely provide.

But the politics of a unilateral move are fraught, since reluctant premiers would cast it as threatening higher taxes and fewer services. Given the damage such a fear campaign would cause, Turnbull has to recognise that just as the commonwealth cannot get rid of the states, so it cannot wrench them from the teat. Financial dependence may bind the states to the chariot wheels of the central government, as Alfred Deakin wrote in 1902, but the central government cannot force them to break free.

That, however, is no reason for simply feeding their habit. Under Turnbull's proposal, budget constraints would have encouraged the states to reform creaking public services; with that proposal dead before arrival, those pressures will have to come from other sources.

The Harper report's recommendations provide an important opportunity in that respect. It is clear from that report that Australia, which once led public sector reform, has fallen behind, forgoing the gains an ever greater number of countries have made by empowering consumers in education and health care. By instead allowing public sector monopolies to dominate areas such as schooling, we have condemned ourselves to a situation where no matter how much we spend, the outcomes invariably disappoint.

No doubt, using competition to improve those outcomes raises tricky issues of market design: competition is a scalpel, not a sledgehammer, and requires a well thought through policy framework. But just as great difficulties were tackled in implementing the Hilmer reforms, so the challenges inherent in this wave of reform are hardly insurmountable.

Setting out principles to guide those efforts, the Harper report establishes a framework for reconsidering national partnership agreements in education and health care. Why not insist the states move towards genuine competitive neutrality in schooling, giving all parents — and not solely those who can afford it — a real choice of school? And how can it make sense for the states to deny public patients the right to be treated in private hospitals, even when those hospitals can undertake procedures for no more than the "efficient price" established by the Independent Pricing Hospital Authority?

None of that is to ignore the benefits the tax changes would have brought. But if the states refuse clearer lines of accountability, the commonwealth has a duty to nonetheless ensure the quality and cost-effectiveness of the services it will be paying for. By renewing competition between public and private service providers, it can at least partly replace the greater disciplines on public spending proper fiscal federalism offered.

That won't solve the problem of vertical fiscal imbalance, with its tangled responsibilities and perverse incentives. And it would be understandable if the government wrote off reform of the federation, as has repeatedly happened in the past. But in Australian federalism, the choice is never between the best and the merely desirable; almost always, it is between the barely palatable and the absolutely disastrous. Given the state of our states, this is no time to give up.