

## MENZIES RESEARCH CONFERENCE: THE FUTURE OF FEDERALISM

**Improving the delivery of public services in the Federation**

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Thank you for the opportunity to address this conference today. I want to start by dealing with a few issues related to the role of Federalism, and then turn to the specific challenge of State government service delivery.

Although the costs of our federal system are often emphasized, less attention is paid to the benefits that federalism brings, and can, if allowed to, continue to bring. While there are some services, such as national defence, that – given economies of scale and public good characteristics – are best supplied centrally, most public services, including in core areas such as education, health, public transport and policing, can be efficiently supplied on a sub-national level. Moreover, allowing local supply can both enhance accountability and responsiveness to local characteristics, including the preferences of consumers of those services, and – and especially importantly – create scope for experimentation.

The reality is that we do not know, and there is no science which can tell us, what the best way is to educate children, provide good health care, ensure public safety, regulate occupational health and safety or even operate services such as trains, trams and buses. Additionally, it is a fallacy to think we will ever discover the ‘right way’ of doing these things, any more than we will ever discover the ‘right way’ to make cakes, grow rice or design men’s shirts. Rather, changes in technology, in social attitudes, circumstances and preferences, in our economic situation and in our prospects all mean that whatever may seem right and best today will not do so tomorrow. As a result, it is critical that our polity provide the scope for new ways of doing things to emerge.

In the private sector, this is not something we need to worry about, or at least worry about too much. By and large, given reasonable intellectual property rights, markets do a good job of encouraging innovation and rewarding innovators. The incentives and mechanisms for innovation are, however, much more muted, and the space for innovation is much more constrained, in the public sector, especially in those areas which are provided as monopolies (such as public safety), which are heavily regulated, or where the government both finances and provides the service, usually at prices that bear little relation to cost (and which hence discourage the development of competing alternatives).

Federalism is one important way in which we allow that innovation to occur. The phrase commonly attributed to Mao springs to mind: “let a thousand flowers bloom and a hundred schools of thought contend”. In fact, the phrase Mao used in the summer of 1957 was “let a hundred flowers bloom, let a hundred schools of thought contend”. More importantly, it appears that Mao’s purpose in launching that slogan was to incite critics to speak out so that they could be identified and eliminated, usually through prompt public execution. A federal system provides the room for the flowers to bloom without the fear that as they emerge, a zealous central planner will immediately cut them down. Indeed, experience with FuelWatch shows that the

zealous central planner may embrace some ideas, developed at State level, that would have been better strangled at birth.

Providing scope for experimentation does not only provide localised benefits in the form of better ways of doing things – it is also crucial to effective accountability. In effect, one of the best guides the public can have about how public sector service providers are performing is to compare what they offer to what is being done in other States and Territories. This type of competition – which economists refer to as ‘yardstick competition’ – can and should be harnessed to bring greater discipline to public sector service providers, as well as to State governments generally. Through the pressures it creates, whatever is done that is best can be taken up throughout the federation.

I have heard it argued that because of increased economic integration, both within Australia and between Australia and the rest of the world, these benefits of federalism are no longer as great as they once were, while the costs of having multiple jurisdictions have become larger. Underpinning this argument are two propositions, both, in my view, either flawed or exaggerated.

The first is the belief that in a more integrated economy, differences between jurisdictions – for instance, in occupational health and safety regulations – impose greater losses in terms of foregone economies of scale. While this indeed has some truth, it is not entirely correct and even to the extent to which it is correct, does not support the conclusion that federalism is no longer beneficial. In effect, it follows from the same fact of much closer economic integration that the prize that markets deliver to those jurisdictions which ‘get it right’ is correspondingly greater. This is simply because with people and resources more footloose and greater scope to supply goods and services remotely, economic, social and cultural activity increasingly migrates, and migrates quickly, to those places that perform best, including in terms of infrastructure and “social capital”. As a result, the increasingly integrated character of the Australian economy can make inter-jurisdictional competition a more, rather than less, effective mechanism, both in terms of increasing the incentives for jurisdictions to ‘get it right’ and in terms of ensuring that activities go to where they can be undertaken most efficiently.

The second proposition that those who claim that federalism is passé advance says that the yardstick or benchmarking benefits of federalism are no longer relevant, as we can so readily compare ourselves to the world outside Australia. That we can compare ourselves to the rest of the world is of course true, but then again, has long been so. Indeed, international comparisons play, and have for many decades played, a major role in the evolution of public policy in areas such as education, health and policing. But the important point is this: that the more differences there are between ourselves and the people and places we are using as the comparators, the more difficult it is to learn from the comparisons being made. The enduring benefit of federalism is that it allows us to make comparisons to others who are very much like ourselves. As a result, if an approach works better in Queensland than the approach currently being pursued in Western Australia, it is more likely to also be an improvement should Western Australia adopt it. Moreover, the fact that we are in the same polity, and covered by the same media, reduces the costs we incur in observing

and assessing developments, and makes the learning process far more timely than it would otherwise be.

All of this means that the case for federalism is as strong as it has ever been. Now federalism does not mean secession: the relevant jurisdictions remain within a common entity, an entity vested with substantial powers and responsibilities. There are obviously areas – one thinks of the current crisis in the Murray-Darling -- where policy coordination is vital. And here too, the advantage of federalism is that, at least ideally, it should allow for that coordination to occur in those areas where its net benefits are greatest.

That said, the reality is that few reasonable observers would conclude that our State and Territory governments do a good job, much less as good a job as could possibly be done, of delivering core public services. Fairly or not, dissatisfaction is widespread across many areas of public service provision, ranging from education to criminal justice, health to community services, public transport to policies for indigenous Australians. At times, expectations may be unrealistic; but there is more than an ounce of truth to the view that the States and Territories are failing their citizens.

What is striking here is that State and Territory governments have benefited from substantial increases in revenues over the last decade. These revenues have largely been spent on providing core public services, and within that, mainly in paying for the labour inputs used to supply those services. Yet one can look at a broad range of performance indicators – whether it be in the public hospital system, the public schools, or policing – without seeing material improvements. At best, the indicators tend to be mixed; in some cases, they seem to be going backwards.

From an economic perspective, it is unsurprising that governments do not do a great job in providing public services.

In competitive markets, supply is abundant and as far as each supplier is concerned, customers are scarce and must be competed for. The pressures and constraints that arise from that search for customers create incentives to control costs, improve quality and develop new ways of doing things. The profits that can accrue from success in this quest, and the losses that can arise from failure, make these incentives all the greater.

In markets for public services, the opposite holds: prices that are low or even set at zero mean that customers are abundant, while supply is scarce. Moreover, the costs of the service are spread over the mass of taxpayers, so that increases in costs are less visible and have fewer or even no consequences in terms of loss of custom. Finally, innovation is often disruptive and painful for suppliers, who get little benefit themselves from doing things better.

The outcomes that emerge in this situation are hardly ideal. All too often, control over the supply of the service is ‘captured’ by the providers themselves. In many instances, these providers face budget constraints that are weak, all the more so as governments find it difficult to impose binding budget disciplines, particularly in environments that are extensively unionised. However, even when there are binding budget disciplines, there is little that ensures that what budget there is, is used to best purpose, with the

result that attempts at budget capping are a very blunt instrument at best – an instrument that ends up inflicting the greatest punishment on vulnerable consumers, rather than actually promoting more efficient supply of the services.

Consider, for example, community services. We have periodic ‘blitzes’ on fraud by beneficiaries, and that is as it should be. But those blitzes coexist with excess costs in the supply of the service, with little being done that really addresses the sources of fraud, improves the behaviour of and outcomes for recipients and their families, or genuinely increases the overall effectiveness with which the service is provided.

We can end up, in other words, with a particularly unpleasant version of the “nanny state”: one that flogs the children, while treating the nannies to oysters and champagne. But however popular this version of the “nanny state” is with the nannies, it is both inefficient and ultimately ineffective.

Long experience shows that there are no silver bullets or magic wands that can solve these problems. That said, there are approaches that can make matters better, and others that can help make them worse.

There are few better ways of improving matters than to promote choice and consumer sovereignty, wherever one reasonably can. Education, including vocational education and training, health care, and community services, are areas where the scope for greater and more effective consumer sovereignty is especially clear.

The Howard government was alert to these possibilities and did actively seek to expand choice.

In health care, for example, this was done by first stopping and then reversing the death spiral in which private health insurance was gripped, and using an expanded private health insurance system to support the rapid growth of a private hospital sector. As that process played itself out, an increasing share of Commonwealth health care funding was devoted to private sector alternatives.

Thus, in the 2005-06 financial year, the Commonwealth provided over 90 per cent of the funding to private hospitals. By then, this area of expenditure had grown eight-fold since 1995-96, from \$381 million to \$2,639 million, with government expenditure on private hospitals rising over that period from less than 3 per cent of the total hospital funding budget to just under 11 per cent.

When account is taken of that shift, and quite contrary to what is repeatedly claimed by the Labor states and by the current Commonwealth government, the Commonwealth share of direct hospital funding remained stable over the period – in 1995-96, the Commonwealth accounted for 50.33 per cent of total (Commonwealth plus State and Territory) expenditure on hospitals; for 2005-06, the Commonwealth’s share of total hospital funding was 49.98 per cent. But what there had been is a rebalancing from funding of public providers to a somewhat greater weight on private providers. That rebalancing largely reflected (though it doubtless also permitted) choices made by patients and their families, as well as by medical professionals – primarily, a choice to make greater use of private health care facilities.

A similar pattern emerges in education. While funding responsibilities for education are complex, States and territories are primarily responsible for government schools while the Commonwealth is primarily responsible for grants to non-Government schools. Here too, the Howard government provided substantially increased funding for non-Government schools, accommodating and permitting an increase in the proportion of students going to those schools.

Thus, while Commonwealth spending increased in real terms for both Government and non-Government schools during the Howard years, the share of funding between the two school sectors changed, with the share for Government schools dropping from 42 per cent in 1995-96 to an estimated 32 per cent in 2003-04. The shift in Commonwealth funding between the two sectors is also reflected in Gross Domestic Product (GDP) shares, with the non-Government sector's share of Commonwealth SPPs for schools growing from 0.39 per cent in 1995-96 to 0.50 per cent of GDP in 2002-03, while the Government school sector's share remained steady at 0.28 per cent. This means that funding from the Commonwealth to Government schools grew in line with GDP, which itself was growing especially rapidly.

These Commonwealth contributions need to be seen against the backdrop of the pattern of expenditures by State and Territory governments. Specifically, while State and Territory Governments do contribute, albeit to varying extents, to recurrent funding of non-Government schools, the funding they provide is typically small relative to that provided to Government schools. Thus, although roughly a third of New South Wales schoolchildren attend non-Government schools, those schools were allocated \$773.7 million in the 2007-08 State Budget, as compared to \$7,863.1 million for Government schools.

These figures refer to recurrent (operating) expenditure, rather than capital grants. The capital needs of Government schools are funded entirely by government, with New South Wales, for example, allocating \$531 million for construction and enhancement of schools. By comparison, direct Commonwealth grants from the Capital Grants Programme in New South Wales for the same period are \$96 million for Government schools and \$38 million for non-Government schools. Capital funding for non-Government schools is therefore heavily reliant on contributions from parents and on donations more generally.

The result is that Government schools continue to receive far greater public funding per student than do their non-Government counterparts. Specifically, total government spending on Government schools per Full Time Equivalent (FTE) student (that is, taking account of spending by Commonwealth and State Governments) still substantially exceeds total government spending on non-Government schools per FTE student. Thus, in the 2005 financial year, real Commonwealth, State and Territory Government recurrent expenditure per FTE student in all Government schools amounted to \$10,715 compared to \$6,054 for non-Government schools.

In short, State and Territory funding remains very largely directed at Government schools. The Howard Government, on the other hand, somewhat righted the balance by expanding its funding of non-Government schools.

This has been portrayed as providing subsidies to the well-off. This ignores the fact that a significant factor in the growth in non-Government schools over the last decade was the emergence of new, lower-fee independent schools in areas which historically had no non-Government schools (other than Catholic ones) and which have income levels that are relatively low. At the same time, the expansion of Protestant, Muslim and other faith-based schools provided the option of school choice to a much larger group of Australians than ever before. These schools rarely fit the image of the traditional, elite-oriented, private school, including in terms of the socio-demographic communities they serve. Providing public funding to these schools is far more likely to improve the distribution of educational opportunity than to worsen it.

In these ways, new choices were created for consumers of core public services. The challenge now is to keep pushing out the frontiers of that choice. There is still a great deal that can be done to make public funding more portable, and to put consumers into a position where they have far more access to the information required for choice to be effective. Thus pushing out the frontiers of choice is crucial for two reasons.

First and most directly, greater choice reduces consumers' vulnerability to the services provided by State and Territory governments.

Second, increasing the options consumers have places real pressure on public sector service providers to perform. It means that when costs are improperly shifted onto consumers, or quality is degraded, consumers, by voting with their feet, can punish the poor performers. This is by far the best way of genuinely promoting efficient public sector service provision.

Given this expansion of choice, it should then be up to State and Territory governments to lift their game. They can, and should, be accountable for whether or not they succeed in that respect. Faced with that pressure, one would hope for genuine innovation in service delivery, innovation that a federal system is ideally placed to encourage and benefit from.

Set against that option, I would now like to turn to approaches that are not solutions – but rather, are merely likely to aggravate the underlying problems.

The first of these is the misplaced emphasis on uniformity or harmonisation. The EU's fabled "eurosausage" springs to mind. But even putting those extreme cases aside, there is no sensible reason why education systems, health systems, or other public services should be the same throughout Australia. Nor is there any sensible reason for having the same licensing laws, the same occupational health and safety standards, or the same system of industrial relations. Moreover, if one tries to have a uniform approach, the risk is that we will eliminate the best and – in the most optimistic outcome – end up with a watered down version of the worst. Of course, this is not to deny that the differences are annoying, messy and far from costless, but these need to be set against the very substantial benefits diversity brings and can continue to bring, including those I have emphasised above. Greater uniformity would not only force us to forego those benefits, but would also make it ever more difficult for consumers, taxpayers and voters to assess the quality of the services they obtain.

The second, closely related to the first, is what goes under the name of ‘cooperative federalism’, but risks becoming ‘collusive federalism’. What the collusive version of Federalism would involve is the Commonwealth bailing out their State and Territory counterparts, through ever greater funding transfers that ‘paper over the cracks.’ The Building Australia Fund could do this on a vast scale; we are sure to see similar initiatives in the social services as well.

It is said that the funding thus provided will be used to promote efficiency by being made conditional on meeting performance indicators. It remains to be seen what those performance indicators actually involve. Where those indicators are indeed meaningful, and will improve the information taxpayers and consumers can access about how service providers perform, they should be heartily welcomed and strongly supported. But they cannot in themselves solve the problems.

There are important lessons to be drawn here from experience under the Blair government – experience which largely discredited reliance on key performance indicators as a way of securing efficiency gains in the public sector.

In effect, imposing performance targets on public service providers was the battle cry of the first Blair government. Elected in May 1997, by 1998 the Blair government had imposed over 300 “headline” performance targets on departments and agencies. Each of those targets – which were linked to budgetary allocations agreed with Treasury – was accompanied by a large number of more detailed performance indicators, with these cascading into yet further targets at lower levels of service delivery. A single “headline” target could translate into 30 or more “measurable outcomes”, yielding many thousands of indicators in total.

The result was a farce in three parts.

First, the headline targets came to determine the allocation of effort and resources, regardless of how poorly those targets were related to the objectives actually being pursued. As a result, things were done which would otherwise have been regarded as completely unacceptable. For example, so as to ensure patients presenting at emergency would be seen within the four hour target, some hospitals required patients to wait in ambulances outside, until the queues in emergency had reduced to the point where they could be admitted without putting the target (rather than themselves) at risk.

Second, the focus on the targets induced evasion, including through manipulation of data. Just as Soviet managers routinely lied about whether they had achieved production quotas, so “creative accounting” became widespread, including by altering measurement rules to exclude cases that would have led to the targets not being met.

Third, as embarrassments mounted, the system was corrupted to make it less politically troublesome. Targets were made softer; the number of indicators was multiplied to the point where it was impossible to understand what was being measured or achieved; and little effort was put into auditing glowing reports from the field.

Reviewing these outcomes, the Royal Statistical Society concluded that while performance monitoring “is broadly productive” when done well, “done badly, it can be very costly and not merely ineffective but harmful and indeed destructive”.

But the Blairite experience holds a deeper lesson as well. No matter how much thought goes into performance measurement, central planning is central planning, with all of its pathologies. True, firms in the private sector can and do invest in designing better systems for setting goals and tracking performance; but what really drives their performance is the thirst for profits and the threat of displacement, as the loss of custom to competitors provides the clearest signal of the need to lift one’s game.

In short, an ounce of market incentives is worth many pounds of KPIs. If the government wants better performance from public providers of health, education and community services – and performance improvements are surely needed – it would do well to pursue its predecessor’s emphasis on exposing them to competition and choice. That is not because markets are perfect – far from it. But the performance indicator that can do better remains to be invented.

For all of these reasons, it is, in my view, an illusion to think that throwing Commonwealth money at inefficient public sector service providers, even if it is contingent on meeting performance indicators, will address the underlying problems.

But this approach is not only inefficient in itself; it poses, I believe, a severe threat to the future of our system of government. The greatest long run risk to federalism comes from poor quality State and Territory governments, which bring the system of government into disrepute and creates a climate of opinion favourable to, or at least tolerant of, the progressive strengthening of the centre at the expense of the sub-national units. As that happens, State and Territory politics becomes ever less attractive to people of talent. The result is a vicious spiral, which cannot but put our system of government at risk.

Underpinning this vicious spiral is the difficulty of holding State and Territory governments to account. What will collusive federalism do? It will further blur the lines, making it ever harder for communities to know who should be held responsible for performance. It is all too easy to see a ‘slippery slope’ developing, in which as accountabilities become more and more blurred, centralising shifts in power meet less and less resistance.

It needs to be said that the Howard government, responding also to public pressures, allowed significant moves in this direction to occur, and indeed, undertook several such major moves of its own. But the reality is that moving that way is the opposite from the direction in which we should be going – a direction that should clarify responsibilities more sharply, define and enforce clearer delineations between the responsibilities of the various levels of government and then leave the electorate to judge. If that does not occur, we could readily end up with the worst of all worlds – all the duplication that characterises federal systems, with none of the benefits that federalism can and should bring.

In short, there are three keys elements to reviving our federal system.



First, we need to be clearer in explaining and defending the enduring benefits federalism brings.

Second, we make States and Territories genuinely accountable for the services they provide by leaving them to manage those services, rather than allowing the lines of accountability to become as blurred and tangled as a COAG org chart.

And third, we need to push ever more strongly to expand the frontiers of choice.

Ultimately, responsible government and the freedom to choose are the pillars of a liberal, effective and efficient federation. It is time they were brought back to the fore in the “battle of ideas”.