

## Chapter 4

### The Case for Competitive Federalism

*Senator David Leyonhjelm*

My party, the Liberal Democrats, supports competitive federalism. I know this is a key concern of The Samuel Griffith Society. It is what I plan to talk about in this address.

Most Australians would shake their heads if you asked them what competitive federalism meant. As a Senator, I hope to change that.

Quite often you hear the claim that we are over-governed. It is true. But the solution I often hear is to abolish State governments. For a very good reason I do not agree with that.

Many eminent economists believe that both our prosperity and individual liberty would be enhanced by moving away from the cooperative federalism that we now have in Australia, and returning to the competitive kind we once had.

Wolfgang Kasper, Emeritus Professor of Economics at the University of New South Wales, is one of them. He labels our present system as “hollow federalism,” and says it is to our nation’s detriment. He believes pitting State against State is a surer way to a more prosperous and free society.

It is not just economists. Bob Carr, long-time Premier of New South Wales, deplores that “Australia has the most centralized federal system in the world.”

There is also philosophical and historical support. Thomas Jefferson advocated for the counties of the individual States to be divided into wards, which would effectively be “elementary republics” where “the voice of the whole people would be fairly, fully, and peaceably expressed, discussed and decided by the common reason” of all citizens.

Like Professor Kasper, we want to see the States more autonomous and with the right to levy taxes. In our view that would encourage competition between the States in pursuit of economic growth and development. Competition spurs innovation and spawns a host of entrepreneurs resulting in more jobs.

We place an important proviso on this. We consider Australians are already overtaxed, so this change should occur in the context of a reduced overall tax burden.

Competitive federalism was a bedrock policy when our Constitution was framed. The political leaders of the States gave their governments the right to levy income tax with minimal involvement by a distant central government tasked with the management of a few national responsibilities, most importantly external affairs and defence.

Those wise men knew what they were doing. As Niall Ferguson, one of the most authoritative historians of modern times, put it – the evolution of competition between political bodies is the killer app of Western capitalism.

James Allan, Garrick Professor of Law at the University of Queensland, has experienced the many benefits of competitive federalism in his native Canada. He says: “You have better outcomes across a range of criteria when states have real power and are not at the mercy of central government’s diktats.”

Professor Allan cites the United States as an example of the benefits that derive from the diversity in social and economic systems enjoyed by its citizens. “You can live in high taxing, high service providing California, or low taxing, fewer services providing Texas.”

The Australian Federation has evolved into a cluster of mendicant States, economically reliant on handouts from the Commonwealth. Our founding fathers would have been shocked to witness how the federal system of funding regressed into the unedifying spectacle of the State premiers, like medieval serfs, trudging up the hill to Canberra Castle, tugging their forelocks, to be given handouts at the discretion of the all-powerful Laird, the Prime Minister.

Too often, in an embarrassing spectacle, they trudged back down the hill loudly bemoaning the meanness and hard-heartedness of the Laird.

Even with the goods and services tax (GST) allocated to State governments, the Federal Government decides how it is divided among them. The most successful States, such as Western Australia, get much less back than they generated, while the least successful States, such as Tasmania, get far more. So, failure is rewarded and success is punished.

Maurice Newman, the former chairman of the Australian Stock Exchange and now chairman of the Prime Minister’s Business Advisory Council, derides this system as “socialist horizontal fiscal equalisation.”

Professor Allan says, “I cannot think of another functioning federal democracy where States don’t have income taxes.” The United States, Germany, France, Switzerland and various other modern democracies all have one form or another of competitive federalism, with the power to impose income tax on their citizens shared between the States and each central government.

Switzerland has 23 states, known as cantons, which compete with each other in offering low taxes to attract multinationals to establish regional headquarters or other operations there. Even though Switzerland is competing with other regional economies such as the Netherlands and Germany to attract business, its low tax rates, prompted by competition among the cantons, are a huge attraction.

Switzerland’s general corporate tax rate is 8.5 per cent. When average cantonal and municipal taxes are included, the average corporate tax rate in Switzerland is 21.2 per cent, compared with about 30 per cent for Germany and 25.2 per cent for the Netherlands.

The cantons are snapping at each other’s heels. Schaffhausen, north of Zurich, near the German border, halved its corporate tax to 16 per cent, in 2008. Obwalden, south of Zug, undercut Zug to introduce the lowest corporate rate in Switzerland, 12.7 per cent, attracting 450 small companies for each of the past three years, netting 2,000 new jobs. Rather than seeing big business as a cow to be endlessly milked, which every level of government in Australia seems to regard as absolute truth, the Swiss cantons vie to bring business into their locations, particularly multinationals. And taxing them less, not more.

Many here would know that the States lost the power to levy income taxes in 1942. The same year Queensland, Victoria, Western Australia and South Australia challenged Canberra over the grab in the High Court but lost the case. As we all know, the Commonwealth has retained that sole right ever since.

An inevitable consequence has been the expansion of the Australian public service. The most dramatic rise took place during the first decade of this century, almost all of it under the

leadership of John Howard, when the number of Australian public servants rose by 40 per cent, from 110,000 to 155,000.

The population of Australia did not rise by anything near 40 per cent during that period. Many more Commonwealth departments and regulatory bodies were created. More and more, services that were once the sole responsibility of the States were seized or shared by the Laird and his crowd of courtiers in Canberra.

The National Commission of Audit recently proposed that the Commonwealth make room for the States, perhaps by dropping its own personal tax rate by ten percentage points. The States could then charge a State income tax on top of the Commonwealth tax. Some could charge all or most of the 10 per cent while others could charge much less.

I prefer all Commonwealth involvement in health and education to cease, but implementing the Audit Commission's suggestion would be a start. Once the States are no longer beholden to the Commonwealth for everything, they should be willing more often to tell the Commonwealth to keep its greedy snout out of their business.

That can only be to the good of our country. Competition between the States should not only be about financial management, but also social questions. The success of State governments should be based on how attractive they can make their States to live and work there.

The Government needs to be encouraged, prodded and kicked on this issue. I am expecting to do just that. But let us be realistic; this is probably a long-term goal.

I am just one voice, but every journey has to start somewhere. For at least the next two years, and perhaps six, I will be part of the balance of power. I will be using that to push this issue.

And I would encourage each of you to raise your voices also. Together we might make a difference.