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## An Assessment of the Australian Government's Roads to Recovery Program

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**Abstract:** Australian local government is widely acknowledged to be under severe financial distress that has been mainly manifest in local infrastructure under-investment. The Commonwealth government's Roads to Recovery (R2R) funding program has provided substantial funding relief to municipalities to provide local roads. However, the sheer monetary scale of R2R and its direct funding of councils make it unique in Australian fiscal federalism and thus eminently deserving of research effort. Unfortunately R2R has been almost completely ignored by the academic community. This paper seeks to remedy this neglect by exploring R2R from two perspectives: The legal status of R2R and its economic characteristics in terms of the theory of fiscal federalism.

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## Introduction

It is now universally acknowledged that all Australian local government systems face daunting financial constraints that severely inhibit their operations, especially in terms of adequate local infrastructure maintenance and renewal. This state of affairs has been repeatedly confirmed in several recent inquiries into Australian local government, including the Commonwealth Grants Commission's (CGC) (2001) *Review of the Operation of Local Government (Financial Assistance) Act 1995*, the Commonwealth House of Representatives Standing Committee on Economics, Finance and Public Administration's ('Hawker Report') (2003) *Rates and Taxes: A Fair Share for Responsible Local Government*, the South Australian Financial Sustainability Review Board's (2005) *Rising to the Challenge*, and the Independent Inquiry into the Financial Sustainability of NSW Local Government's (LGI) (2006) *Are Councils Sustainable*. While the main reasons for this financial distress are generally well understood, debate continues on how best to deal with the problem.

It is also widely acknowledged that the financial plight of Australian local government would have been substantially worse had it not been for the introduction of the Commonwealth government's *Roads to Recovery* (R2R) funding program. The R2R initiative began life as a response to the looming problem of a local road stock that was reaching the end of its useful life. The finance required to renew the declining network of local roads was deemed beyond the capacity of local government. As a consequence, in November 2000, the Commonwealth government announced that it would inject \$1.2 billion into local road renewal, 70% (or \$850m) of which was to be spent in rural and regional Australia (DOTARS 2003a, 1).

The R2R program was initially designed to cover the period January 2001 through to June 2005. However, following a review of Commonwealth transport infrastructure funding in 2002, R2R was extended (under the banner of AusLink) and will now finish in 2009. In total, covering the period 2001

through 2009, the program will outlay about \$2.55 billion in local road funding (DOTARS 2006b, 7). The financial arrangements underlying R2R completely by-pass state and territory governments, and thus represent a direct grant from the Commonwealth to local councils. One of the many conditions placed on use of the funds is the maintenance of a weighted average of previous local road expenditure by recipient councils. This stipulation enables us to classify R2R grants as targeted close-ended conditional block grants. While the requirement to maintain previous funding levels makes it tempting to characterize the program as a matching grant, a matching rate is not explicitly stated.

Despite the undoubted financial relief that the R2R program has brought to struggling local councils across Australia, it remains embroiled in controversy. In the first place, although the Commonwealth has been previously involved in the direct finance of local government through various programs, R2R has broken with longstanding tradition in Australian fiscal federalism by its sheer scale in bypassing state and territory governments that have typically redistributed federal funding to local government through their Local Government Grants Commissions. It may also violate the Australian Constitution. In addition, political opponents of the program have stigmatized it as 'pork barreling' on a grand scale that has been calculated to secure the federal government partisan advantages in marginal electorates, particularly in non-metropolitan seats. Other critics have questioned the efficacy of R2R in achieving its stated aims of upgrading the local roads network (see, for example, ANAO 2006).

Despite this criticism, with some exceptions, most notably Leigh (2006), very little scholarly effort has been directed at analyzing R2R. Given the size and duration of R2R, as well as the new ground it breaks in terms of Australian fiscal federalism, this neglect is most unfortunate. The present paper thus seeks to at least partly remedy this oversight by examining both the constitutional foundations of R2R and its economic characteristics in the light of the theory of fiscal federalism.

The paper itself is divided into four main sections. The first substantive section of the paper provides a brief synoptic review of R2R by way of background. Section two considers the constitutional standing of R2R. Section three examines the economic characteristics of R2R through the prism of the modern theory of fiscal federalism. The paper ends with some concise concluding remarks in section four.

### ***Roads to Recovery Program***

In any federal system of government, expenditure functions and revenue-raising powers have to be assigned between the various tiers of government. In real-world federations, two problems invariably flow from the assignment of tax and expenditure functions: Vertical fiscal imbalance (VFI), where different tiers of government cannot match their financial responsibilities with income they generate themselves; and horizontal fiscal imbalance (HFI), where governments at the same level achieve differential financial capacities to fund their assigned functions. Over the past century of Australian federalism, the problem of VFI has grown steadily more acute, especially between the federal government and state and territory jurisdictions (Mathews and Grewal 1997; Dollery 2002).

In principle, VFI can be addressed in four main ways. Expenditure responsibilities can be transferred between the different tiers of government in a multi-government system, taxation powers can be re-assigned, revenue-sharing arrangements can be instituted, and intergovernmental grants can be employed to redistribute funds. In Australia, all of these methods have been invoked since Federation.

R2R may be described as an additional attempt to alleviate VFI since it involves grants made directly from the Commonwealth to local councils. However, because it bypasses state and territory governments, and incorporates very large sums of money, it differs from previous

institutionalized methods of redistributing federal funds to lower tiers of government. Moreover, since it involves disproportionately more monies going to rural and remote local authorities, rather than to their comparatively more affluent metropolitan and regional counterparts, it may also be said to address HFI amongst local councils.

With respect to the finance of the Australian road network, the distribution of funding between the states and territories from the Commonwealth follows a well-defined and familiar formula. Road funding to states and territories is based on historical precedents, length of local roads and population, while allocations between councils within each state is determined by a historical sharing arrangements, which in turn depends on a variety of matters, such as total road length and road condition. Over the long term, this has at least facilitated funding certainty and administrative convenience, if not strict adherence to economic efficiency principles.

When the R2R program began, local councils were required to register with the Commonwealth Department of Transport and Regional Services (DOTARS). Initial funding was triggered by submission of a schedule of works. Each quarter thereafter, councils had to submit a report on work carried out, including expenditures, and an updated schedule of anticipated works. The difference between these two financial accounts is then credited to the council in question. In effect, the federal government makes an advance payment to councils for road construction and maintenance work yet to be carried out.

However, there is obviously scope in the R2R scheme for the diversion of funds by councils to other expenditure items not related to roads. To guard against this, and to measure the impact of the scheme itself, under R2R guidelines local authorities are required to report annually on how they spent R2R funds. The reports must be both detailed and made public to facilitate accountability.

Some idea of the actual quantum of funds (in nominal dollars) either expended or designated under the R2R program can be gathered from the fact that between January 2001 to June 2005, some 1.2 billion dollars was allocated by the Commonwealth, with a further estimated 1.35 billion to be spent between July 2005 and June 2009 (DOTARS 2006b, 9). Table 1 shows the distribution of funds already expended between the different states and territories.

**Table 1: State distribution of funds (January 2001 to June 2005)**

| <b>State</b> | <b>Funding (\$m)</b> |
|--------------|----------------------|
| NSW          | 340                  |
| Vic          | 250                  |
| Qld          | 250                  |
| WA           | 180                  |
| SA           | 100                  |
| Tas          | 40                   |
| NT           | 20                   |
| ACT          | 20                   |
| <b>Total</b> | <b>1,200</b>         |

Source: DOTARS (2006b, 9).

DOTARS (2006b, 15) has reported that approximately 15,000 road projects have been funded over the life of R2R to date. Classified by type of project, the nature of the projects can be decomposed as follows:

- Almost 34 % involved reconstruction, rehabilitation and widening of local roads;
- More than 14 % involved sheeting and re-sheeting gravel roads with a new surface;
- Nearly 12 % involved sealing along sections of gravel roads; and
- Over 10 % involved bridge or drainage works, with about 700 bridges replaced or repaired (DOTARS 2006b, 16).

We have already stressed that, while direct Commonwealth financial assistance to local government has long been in place, most prominently through Specific Purpose Payments (SPPs), the R2R program nevertheless

breaks new ground in Australian fiscal federalism in terms of its sheer size in bypassing state and territory governments. Table 2 provides an indication of the quantum of R2R funding relative to Commonwealth SPPs over the period January 2001 to June 2005.

**Table 2: Contribution of Roads to Recovery funding to total Commonwealth Specific Purpose Payments (January 2001 to June 2005)**

| <b>Financial Year</b> | <b>R2R Funding</b> | <b>Total SPPs</b> | <b>Percentage R2R</b> |
|-----------------------|--------------------|-------------------|-----------------------|
| 2000-01               | 33,661             | 104,206           | 32.3                  |
| 2001-02               | 416,339            | 496,067           | 83.9                  |
| 2002-03               | 200,000            | 276,986           | 72.2                  |
| 2003-04               | 300,000            | 356,030           | 84.3                  |
| 2004-05               | 249,922            | 310,838           | 80.4                  |

*Source:* DOTARS (2001), (2003a), (2003b), (2005), (2006a).

Finally, it has been suggested that whereas the R2R program is primarily aimed at alleviating VFI between local government and higher tiers of Australian government, it also addresses the problem of HFI between local councils by predominantly targeting non-metropolitan councils that are generally less well resourced than their city counterparts.

## **Constitutional Perspectives**

It can be argued that spending under the Commonwealth's R2R Program violates the Australian Constitution (the 'Constitution') and that these payments are thus unlawful. This claim necessarily implies that both the Commonwealth Auditor-General and the states have turned a 'blind eye' to the usurping of a state constitutional responsibility.

This section of the paper seeks to trace the legislative history of R2R and contends that the supposed use of the appropriation power under s 81 of the Constitution does not provide the authority to make direct payments to local government. Solutions to correct this potentially illegal conduct are

canvassed, including the use of the New States and Territories provisions found in Chapter VI of the Constitution and recourse to the amendment procedure in s.128 of the Constitution.

### *Legislative History*

Australian federalism is based on the concept of the division of powers and functions between the states and the Commonwealth government. Under s 51 of the Constitution there is assigned to the Commonwealth Parliament a number of topics upon which it can legislate. It seems clear that the construction and upkeep of local roads is not one of them.

The nature of the Australian Federal System was remarked upon by Gleeson CJ in *Austin v. Commonwealth* (2003 215 CLR 185 at 211):

[I]t involves the co-existence of national and state or provincial governments, with an established division of governmental powers; legislative, executive and judicial. As in the United States, the national government was given limited, specified powers. An approach to constitutional interpretation which stressed a reservation of State powers flourished for a time after federation, but was reversed by the Engineers' case in 1920. Even so as in the United States, the federal nature of the Commonwealth has been held to limit the capacity of the Federal Parliament to legislate in a manner inconsistent with the constitutional role of the States.

The first group of payments was made under the Commonwealth's *Roads to Recovery Act 2000*. This Act consisted of 13 sections and provided for the appropriation of \$1.2 billion to local government by 30 June 2005. \$850 million was spent on rural and regional roads and the remaining \$350 million on suburban city roads (R2R, Annual Report, 2002/2003). Section 4 simply stated that 'the main object of this Act is to provide \$1,200,000,000 for road expenditure by local governing bodies' and s 6(3) provided that 'the Consolidated Revenue Fund is appropriated for payments under this section'. In short, there was no pretence by the Parliament that the appropriation of



these monies fell within any purpose of the Commonwealth listed in s 51 of the Constitution or indeed elsewhere.

The second group of payments, to be made under the *AusLink Roads to Recovery Program* provides for the spending of a further \$1.2 billion over the four years to 30 June 2009. Part 8 and in particular s 89(4) of the Commonwealth's *AusLink (National Land Transport) Act 2005* provides that payments are to be made under funds appropriated by the Parliament. In addition, the Commonwealth Treasurer announced in his 2007 Budget speech that the 'Australian Government will pay an additional \$307.5 million to Local Councils this year – before 30 June – so Councils can double next year's level of construction'.

#### *The Appropriations Power: A Vehicle to Bypass the States?*

In essence, the Commonwealth relies upon the appropriations power under s.81 of the Constitution to authorise payments under the R2R Program. But s.81 specifies that 'all revenues or moneys raised or received by the Executive Government of the Commonwealth shall form one Consolidated Revenue Fund, *to be appropriated for the purposes of the Commonwealth* in the manner and subject to the charges and liabilities imposed by this Constitution' (emphasis added).

Section 81 should not be construed narrowly, and should thus be interpreted as allowing the appropriation of moneys to permit the Commonwealth to carry out the usual activities of government, like payments for the executive and the judiciary. Nevertheless s.81 should not be construed as permitting something to be done that is otherwise beyond the legislative competence of the Parliament. Indeed, in the *Pharmaceutical Benefits Case* (1945 71 CLR 237 at 269), Dixon J rejected the idea that the power 'to spend money is independent of the other powers of the Commonwealth'.

However, the key case that appears to have encouraged the Commonwealth to bypass its contrived use of the s.96 power of tied grants to the states is

*Victoria v. Commonwealth* (the *AAP Case*) (1975 134 CLR 338). In essence, funds appropriated for the Australian Assistance Plan under the Commonwealth's *Appropriation Act 1974-1975* for payment of grants to 35 regional councils for social development was unsuccessfully challenged as beyond power. Both Barwick CJ and Gibbs J strongly dissented. The meaning of the words 'for the purposes of the Commonwealth' was central to the construction to be given to s.81. Barwick CJ (at 361-2) observed that '[t]he Commonwealth is a polity of limited powers, its legislative power principally found in the topics granted by s.51 and 52. [T]o say that a matter or situation is of national interest or concern, does not, in my opinion attract any power to the Commonwealth'. Gibbs J (at 374) was of the view that these words, 'do not in their ordinary sense have the same meaning as "for any purpose whatever" or "for such purposes as the Commonwealth may think fit"'.

Five Justices effectively held the appropriation was valid by what appears to be an unworkable mix of diverse reasons. Mason J would have restrained the execution of the plan because it was outside the executive power of the Commonwealth, and in so doing reduced the result to a majority of four. The reasoning in the case is of little utility because it has no predictive value. By contrast, McTiernan J held that the dispute was not justiciable; it was within the field of politics and not law. Stephen J held that the plaintiffs had no standing to bring the suit. But Jacobs J (*supra* at 405) observed that 'the exercise of the prerogative of expending moneys voted by Parliament does not depend on the existence of legislation on the subject by the Australian Parliament other than the appropriation itself'. He further held (at 410) 'that the appropriation of moneys of the Commonwealth Parliament cannot by itself be the subject of legal challenge'.

Finally, and perhaps most importantly, the reasoning of Murphy J seems to go to the gist of the problem. He contended, (at 410) that 'if the plaintiffs' contentions were accepted, it would mean that the Parliament's use of the appropriation power had been unconstitutional since federation'. In short, Murphy J held that the appropriations power was unlimited and that

Parliament is the authority to determine what are the purposes of the Commonwealth. Here he followed what Latham CJ and McTiernan J determined in the *Pharmaceutical Benefits Case*.

The use of the appropriations power in this case can be distinguished from the case where the Commonwealth relied upon the power found in s.51 (xxxix) of the Constitution to enact legislation that was incidental to the execution of the powers of the Executive Government in s.61. For example, the enactment of legislation referable to the commemoration of the Australian Bicentenary was upheld as a valid exercise of the incidental power. In *Davis v Commonwealth* (1988 166 CLR 79 at 94), Mason CJ, Deane and Gaudron JJ remarked that it is 'pre-eminently the business and concern of the Commonwealth as the national government and ... falls squarely within the federal executive power'. Brennan J (*supra* at 111) observed that:

The scope of the legislative power conferred by s 51 (xxxix) in conjunction with s.61 depends on what the Executive Government has done or intends to do in execution of its power. Section 51 (xxxix) confers a power to make a law not with respect to the subject matter of an executive power of the Commonwealth, nor even with respect to a matter incidental to that subject matter; it confers a power to make a law only with a matter "incidental to the execution" of an executive power of the Commonwealth.

It seems to follow that any suggestion that the financing of local government roads is incidental to the execution of the executive power of the Commonwealth could not be sustained.

In common with the Whitlam Labor governments of the 1970s, the present federal Liberal-National Coalition government appears to have used the appropriations power to invade any field of activity that takes its whim. In the present context, the R2R program seems to represent a prime example of this type of conduct. Former Prime Minister Whitlam (1977, 308) observed that:

My Government also employed for the first time on any scale direct money grants 'for the purposes of the Commonwealth' under s.81. *For a number of reasons the making of grants through State Governments unnecessarily complicates the machinery of government.* In the case of the Australian Assistance Plan and the Australian Legal Aid Office, for example, *several States had shown their unwillingness or their inability to provide urgently needed services.* [Emphasis added]

Howard (1984, 24-5) severely criticised the reasoning in the AAP Case. His remarks seem to apply *mutatis mutandis* to the R2R program:

The most basic question posed by the litigation, however, was not squarely confronted at all. This was whether any government should be permitted to utilize an appropriation Act for the purpose of acquiring Parliamentary sanction for a policy which could not be legislatively supported in any other way. It ought to be obvious that, federal questions apart, it borders on the scandalous in terms of governmental practice for Parliament to be presented with two lines of text, amounting to no more than brief and vague headings, as a basis for expending millions of public dollars in such a context. Those two lines concealed an important policy departure which was both new, in the sense that parliamentary sanction had not been gained by normal legislative methods, and highly contentious. The missing legislative methods include debate upon the proposed legislation which deals with the substance of the matter and not simply what it is expected to cost.

### *Standing and Justiciability*

Lane (1972, 824) has suggested that the suppressed reason for not granting a citizen standing to attack unconstitutional expenditure should be sought in convenience. It is claimed that the Commonwealth would be an easy target because its powers are enumerated and specific.

If this argument is accepted, then the decisions of the Supreme Court of Canada starting with *Thorson v. Attorney-General of Canada* (1975 1 SCR 138) might offer the prospect of the High Court overruling its own attitude to standing. In this case, Thorson Q.C. challenged the constitutional validity of appropriating money to implement the *Official Languages Act (1968-69) (Canada)*. Laskin J observed (at 145):

I do not think that anything is added to the reasons for denying standing, if otherwise cogent, by reference to grave inconvenience and public disorder ... The Courts are quite able to control declaratory actions, both through discretion, by directing a stay, and by imposing costs; ... A more telling consideration for me, but on the other side of the issue, is whether a question of constitutionality should be immunized from judicial review by denying standing to anyone to challenge the impugned statute.... The substantive issue raised by the plaintiff's action is a justiciable one; and *prima facie*, it would be strange and, indeed alarming, if there was no way in which a question of alleged excess of legislative power, a matter traditionally within the scope of the judicial process, could be made the subject of adjudication.

The approach of Laskin J in emphasizing the need to provide legal redress to citizens who challenge allegedly illegal expenditures of public money needs to be argued before the High Court. The Commonwealth seems to be 'pulling itself up by its own bootstraps' by relying on the appropriations power to support activities for which no authority can be found elsewhere in the Constitution. Simply contending that this is the case, does not make it the case.

Some encouragement as to whether the High Court would grant standing to a citizen to challenge the unauthorized appropriation of funds under s.81 may be gained from the remarks of Gleeson CJ and McHugh J where they noted in *Truth About Motorways Pty Limited v. Macquarie Infrastructure Investment*

*Management Limited* (2000 200 CLR 591 at 599) that ‘it is not difficult to understand why, in the case of certain laws, it might be considered in the public interest to provide differently’. In terms of this claim, laws that are claimed to exceed power under the Constitution would be a prime example. Gibbs J observed in *Victoria v. Commonwealth* (1975 134 CLR 338 at 383) that ‘it is somewhat visionary to suppose that the citizens of the State could confidently rely upon the Commonwealth to protect them against unconstitutional action for which the Commonwealth itself was responsible’. Indeed, this view was approved in *Bateman’s Bay Local Aboriginal Land Council v. Aboriginal Community Benefit Fund Pty Ltd* (1998 194 CLR 247 at 263) and where Murphy J (at 425) urged the liberalisation of the requirements of standing for individuals. He later expanded on this theme in *Attorney-General (Vic); Ex Rel Black v. The Commonwealth, (the Defence of Government Schools – the DOGS Case)* (1981 146 CLR 559 at 634) when he observed that:

A citizens’ right to invoke the judicial power to vindicate constitutional guarantees should not, and in my opinion, does not depend upon obtaining an Attorney-General’s consent. Any one of the people of the Commonwealth has standing in the courts to secure the observance of constitutional guarantees.

Of course, constitutional guarantees do not exist. At best there is a duty of the Parliament, the Executive and the Judiciary to uphold the Constitution. Citizens can hold a legitimate or reasonable expectation as referred to by Finn and Smyth (1992, 146) and that it will be administered according to law.

### *The Requirement of Justiciability*

Standing and justiciability, whilst sometimes intertwined, are nonetheless separate issues. In the present context, the asserted ‘matter’ that falls for adjudication is the due and proper administration of the Constitution. For instance, it is only the registered electors who have the power to amend the

Constitution in accordance with s.128. An analogy might profitably be drawn between the rights of an object of a discretionary trust to sue the trustee to require the trust estate to be administered in accordance with the terms of the trust. There the object has no proprietary interest but only a mere expectancy. Along analogous lines, a citizen duly registered as an elector who has no proprietary rights to assert against the Commonwealth, ought to be entitled to enter the 'temple of justice' to challenge the validity of appropriations for non Commonwealth purposes. Even in the *AAP Case*, as noted by Saunders (1984, 49-50), a majority held that the challenge to the appropriation power was justiciable.

### *Potential Solutions*

The framers of the Constitution do not seem to have provided against the states and the Commonwealth acting in a way that has brought about change from a federal union to a *de facto* unitary system. It is trite law that the Constitution does not provide for a national government with unlimited power. To the contrary, it provides for a federal government with specific enumerated powers.

The Australian Parliament does not have a plenary power. Unlike the United Kingdom Parliament it cannot simply 'do what it likes' (Jenkins 2004, 133). However, in contemporary Australia, it is alarming that the citizen is denied access to the High Court to challenge appropriations that are beyond power.

It is unfortunate that the best opinion which the Commonwealth's financial watch dog - the Auditor-General - could give in his recent audit report to the Parliament on the R2R program, was that 'it was *unusual*, in that the funds are provided direct to local government rather than through the States and Territories' (ANAO 2006, paragraph 6) [Emphasis added]. We could add 'who guards the guards'.

In short, the solution to the 'steamrolling' of the Constitution through the apparent abuse of the appropriations power is a political one. If the purpose

underlying R2R is to finance rural regions directly, so as to bypass the states, thereby avoiding the 'flypaper effect' of money 'sticking where it hits', then the remedy is simply to redivide Australia into more states and territories that coincide more closely with local government areas. Commentators in the contemporary political milieu seem to have ignored this potential solution that is specifically provided in Chapter VI of the Constitution. In a similar vein, if new states are deemed unnecessary or too expensive, then new self-governing territories of the Commonwealth might be a possible alternative solution. Finally, a different solution might be to amend the Constitution to give the Commonwealth Parliament authority to legislate in respect of local government.

### **Fiscal Federalist Perspectives**

While the direct finance of local councils by the Commonwealth government has some longstanding precedents in the form of SPPs, the sheer scale of the R2R program introduces a new dimension into Australian fiscal federalism. It has been argued that, at the very least, the R2R program rests on shaky constitutional foundations. But other considerations must also be taken into account. An especially useful method of assessing R2R is to invoke the contemporary theory of fiscal federalism and to evaluate the program in terms of this analytical prism.

In his seminal text that developed the modern theory of fiscal federalism, Oates (1972, vi) defined the economic analysis of multi-unit government as centrally concerned 'what economic theory implies about the division of fiscal functions among levels of government'. In terms of this perspective, the primary objective of the theory of fiscal federalism is to determine which public functions should best be assigned to federal, state or local governments. Most literature in this 'optimal federalism' tradition has concentrated on the most appropriate level of government to deliver the different allocation, distribution, and stabilization activities of the public sector (Musgrave 1959).



The theory of fiscal federalism can help policy makers answer three basic questions that inevitably arise in any multi-tiered system of government (King 1992). In the first place, which powers should be assigned to state and local authorities rather than federal governments? In Australian federalism, the distribution of powers between the Commonwealth government and the states and territories is determined in large part by the Australian Constitution. In common with similar documents in other comparable federal systems of government, the Australian Constitution embodies an historical legacy mostly devoid of any of the efficiency considerations specified in theory of fiscal federalism. However, the enumerated powers of Australian state governments vis-à-vis local authorities, which analogously derive from their statutory inheritance as self-governing colonies, are such that local government is entirely a 'creature' of state government legislatures. The various enabling state and territory Local Government Acts can thus be amended at the whim of state Parliaments, even where limited recognition exists for local government in some state constitutions. It is thus obvious that historical circumstances and past political compromise continue to dominate the formal structure of Australian federalism and the theory of fiscal federalism is useful only insofar as it can help us assess the degree of economic sub-optimality of current federal arrangements.

Secondly, what is the optimal size of sub-national governments? While periodic public debate occurs in Australia over the optimal nature of federal governmental arrangements, political realities make constitutional change very difficult, and this means that constitutional compact between the Commonwealth and state and territory governments remains in tact. Accordingly, questions regarding the optimal size and number of state governments remain largely hypothetical. By contrast, state governments can (and often do) embark on programs of structural reform aimed at changing both the number and size of local councils, typically through compulsory amalgamation of small adjacent councils into larger municipal entities (Dollery *et al.* 2006b). The rationale usually driving local government consolidation programs in Australia rests on presumed economies of scale in local

government, notwithstanding substantial empirical evidence to the contrary (Dollery and Crase 2004). In other words, notions of optimality implicitly drawn from the theory of fiscal federalism have proved very influential in the Australian local government milieu.

### *Optimal local road network externalities policy intervention*

Third, how should state and local governments be financed? In the present context, this aspect of fiscal federalism can shed considerable light on R2R in at least two ways. In the first place, by placing the R2R program in the overall analytical framework of a model of optimal fiscal federalism, we can explore the efficiency and equity characteristics of R2R. In terms of the theory of fiscal federalism, an optimal assignment of functions between different levels of government should be perfectly aligned not only with the benefit region of these functions in terms of the 'correspondence principle', but also with revenue-raising powers just sufficient to cover all costs. However, the problem of externalities (variously known as external effects, external economies and diseconomies, spillovers and neighborhood effects) is ubiquitous in all forms of economic and social interaction, including the relationships between governments and citizens, and in a representative democratic federal polity, between the different tiers of government. In essence, externalities stem from interdependence between consumption and/or production activities and result in a divergence between private and social benefits and costs. The problem posed by externalities is that the resource allocation generated by governments (or markets) will not be efficient because administered and tax prices (or market prices) do not reflect the 'full' or social benefits or costs involved, and accordingly will not yield socially efficient levels of consumption and production if left untouched.

It is possible to identify numerous externalities deriving from the finance of public goods and services in a federal system of government. In the present context of local road maintenance and provision, two main types of spillovers can be identified. Firstly, where VFI is pronounced - as it is in Australian fiscal

federalism - in the absence of intervention by higher tiers of government, local roads will have to be financed exclusively by local councils. If the financial burden of optimal local road maintenance and road provision cannot be borne by local authorities, then under-investment in these activities will result. From the perspective of Australian society at large, the marginal social benefits deriving from local roads will exceed the marginal social costs of local roads, with an aggregate loss of societal welfare. We thus have a *prima facie* case for intervention by federal and state governments. This intervention could take many forms, including either expanding the revenue base of local councils by granting them greater powers to tax and charge, or subsidies through intergovernmental grants, sufficient to ensure an equality of social benefits and costs. In the Australian federal milieu, the problem of externalities attached to local road networks has traditionally been tackled by means of subsidies from state and territory governments to local councils through their respective Local Government Grants Commissions. These subsidies have taken the form of both block general-purpose grants and targeted specific-purpose grants. Under the R2R program, direct Commonwealth government funding is now supplanting these traditional funding arrangements.

Secondly, from an equity perspective, an externality can arise where local roads are used not only by local residents, but also by people from other local, state and national jurisdictions. Put differently, where a local road network generates positive spillovers, a case exists for these externalities to be 'internalised' by a higher tier of government through policy intervention. This intervention could take the form of expanding the local government area until all road users fall within its boundaries, subsidizing the extent of the positive externality through monetary transfers, or even taxing extra-jurisdictional users of the local road network through user charges. In Australian federalism, whereas all three approaches have been adopted over time, the R2R program obviously falls under the grants category and thus is in line with the bulk of financial assistance previously delivered to councils even if it is made in the form of a direct payment.

It is thus clear that the theory of fiscal federalism provides both robust efficiency and equity arguments for intervention by higher tiers of government to capture the positive externalities associated with optimal local road investment and maintenance by local authorities. Moreover, we have seen that the preferred policy instrument in Australian federalism has been intergovernmental monetary transfers, especially from state government exchequers. An obvious difficulty in the application of this policy instrument resides in determining the precise magnitude of the externalities involved in order to calculate the optimal size of the fiscal transfer. Dollery *et al.* (2006b, 97) have observed that ‘enumerating and achieving efficient intergovernmental transfers of this nature is likely to be problematic’, especially ‘in the light of the transactions costs of accurately apportioning spillovers’. Nonetheless, they conclude that ‘economic efficiency can be promoted by employing a higher tier of government as the vehicle for equalizing the costs and benefits of service provision between municipalities’.

What can be said of the current magnitude of intergovernmental in the Australian federal system in terms of these theoretical considerations and where does the R2R fit into these computations? Intergovernmental transfers presently comprise some 12% of total local government revenue. Financial Assistance Grants (FAGS) from the Commonwealth government are paid through the respective state and territory Local Government Grants Commissions in the form of either general-purpose grants or local road grants. These funds amounted to a total of \$1,501 million over the 2003-04 fiscal year (DOTARS 2005). Crase and Dollery (2005) have calculated that, as a proportion of aggregate local government income, FAGS have been falling. Dollery *et al.* (2006a, 4) have argued that ‘the primary reason for this fall is that the real value of these grants is adjusted on the basis of the Consumer Price Index (CPI), which increases more slowly than Commonwealth government tax receipts and GST payments to the states. Moreover, ‘local government costs rise faster than the CPI, largely because they involve labour intensive services closely linked to wage increases’. Despite this downward trend ‘the decline in income from aggregate grants and subsidies has been

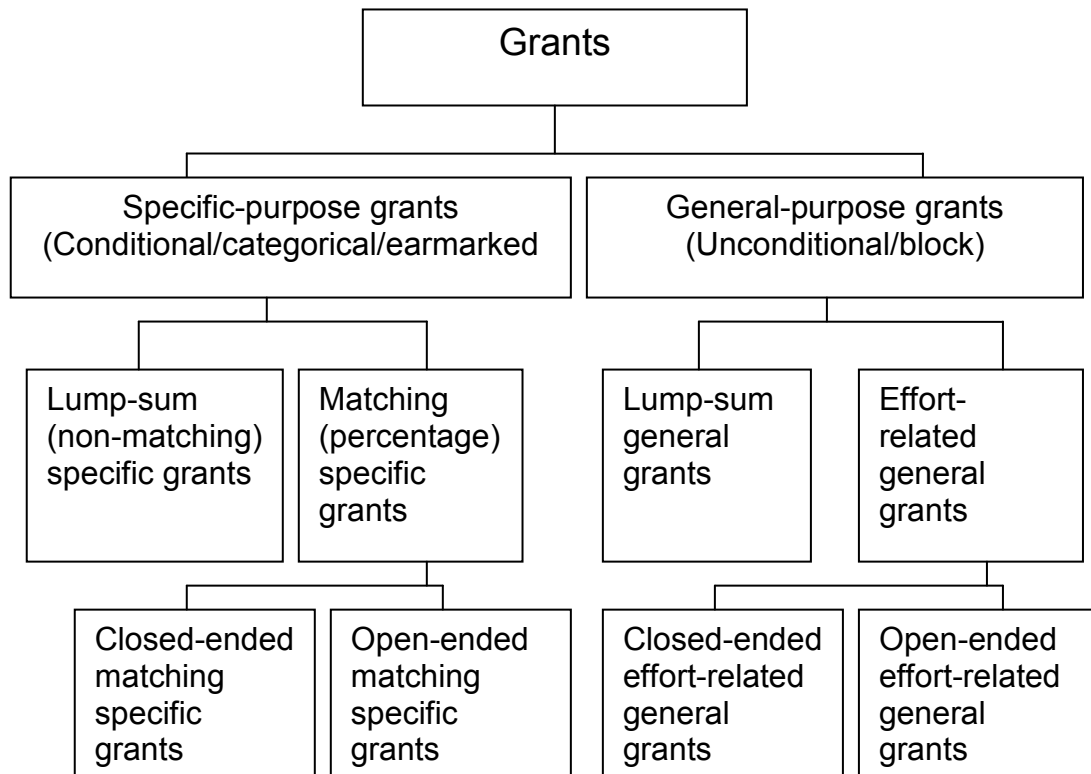
partly offset by the recent Commonwealth *Roads to Recovery (R2R)* program. However, the Department of Transport and Regional Services (DOTARS) *2003-04 Local Government National Report (2005)* calculated that it had still not fully compensated for the fall in other intergovernmental transfers’.

On the basis of these empirical estimates, the R2R program can be justified on both efficiency and equity grounds in terms of the theory of fiscal federalism, despite the fact that it breaks with tradition by bypassing the states and territories in the manner in which the funds are delivered directly to local councils. Furthermore, the putative fact that the total sum of monies does not restore the real value of intergovernmental transfers to local government does not, by itself, constitute either an efficiency or equity argument against the R2R program, merely a caveat that the quantum of funds is insufficient. In any event, it can be argued that the previous and higher regime of FAGS funding through the Local Government Grants Commissions may also have been inadequate to capture the full extent of the externalities involved.

#### *Are R2R grants an optimal method of transferring funds?*

In the second place, the analytical framework provided by the theory of fiscal federalism subsumes a typology of different types of intergovernmental grants and specifies the efficiency and equity characteristics of each these various grant categories. This allows us to draw firm conclusions with respect the suitability of a real world grant program, like R2R, a problem we now investigate.

A substantial literature exists on the efficiency and equity characteristics of different types of intergovernmental grants (see, for example, Jha 1998). Figure 1 provides a schematic summary of the different types of grants.



**Figure 1: A Typology of Intergovernmental Grants**

Source: Dollery *et al.* (2006a, 99).

Following Figure 1, we can distinguish two generic types of intergovernmental grants: General-purpose grants (sometimes referred to as unconditional or block grants); and specific-purpose grants (also known as categorical, conditional, or earmarked grants). This distinction can be further broken down into discrete taxonomies of grants depending on how funds are allocated.

It is evident from Figure 1 that, in contrast to general-purpose grants, specific-purpose grants are targeted at particular types of service provisions, like local road construction and maintenance, and can take the form of a close-ended transfer to local councils. R2R transfers can thus be classified as targeted close-ended conditional block grants in terms of the taxonomy in Figure 1.

What can be said about the efficiency characteristics of this type of grant compared to other grants? Fortunately, the theory of fiscal federalism has a

well-developed literature on this line of inquiry (Jha 1998). In general, it can be demonstrated that specific-purpose grants are inferior in welfare terms to unconditional grants since they distort the behaviour of recipient governments to a greater degree than general-purpose grants due to their differential impact through their income and substitution effects. Moreover, compared to an identical matching specific-purpose grant, R2R-style lump-sum specific-purpose grants will generate less expenditure on local road construction and maintenance (but nevertheless yield greater local welfare gains). We can thus tentatively conclude that targeted close-ended conditional block R2R grants do not represent a 'first-best' method of financing local councils for local road development.

However, this conclusion is derived from traditional welfare economics that uses the social welfare of residents in a defined local government jurisdiction as the yardstick by which to gauge the characteristics of different types of grants. If a different objective of policy is employed instead, then different conclusions can be drawn. In the present context, if we assume that the Commonwealth government wishes to maximize the amount of local road construction and maintenance from a given sum of R2R funds, then matching specific-purpose grants will be more effective in achieving this aim.

## **Conclusion**

This paper has argued that Australian local government finds itself in dire financial circumstances. The results of this funding crisis have been mainly evident in insufficient local infrastructure development, especially in non-metropolitan local roads. Moreover, although the Commonwealth R2R program has by no means solved the deficiencies in local road construction and maintenance, without R2R funding the problem would be much more acute. It would thus appear that there is a strong *prima facie* case for direct Commonwealth finance of local roads in the absence of corresponding monetary efforts by the states and territories.

However, this conclusion must be subjected to at least two caveats. Firstly, although direct funding of local councils by the Commonwealth is by no means new in Australian federalism, the constitutional status of this form of federal intervention is open to question. We have sought to show that R2R can be construed as violating the Australian Constitution and may thus be illegal. Furthermore, it has been argued that various avenues exist that could potentially remedy this putative problem.

Secondly, it has been claimed that the R2R program can easily be justified on both efficiency and equity grounds deriving from the theory of fiscal federalism since the local road network exhibits strong positive externalities. However, general-purpose rather than unconditional grants would have enhanced local welfare to a greater degree, whereas matching specific-purpose grants would maximize the quantum of local road construction and maintenance from a given amount of R2R finance.

The paucity of academic work on the R2R program means that these conclusions should not only be regarded as tentative, but also by no means exhaustive of the potentially rich analytical approaches that can be used to explore the efficacy of the R2R grants. For instance, 'pork barrelling' could be investigated by statistically estimating relationships between the aggregate of funding delivered through R2R to particular federal electoral seats and the marginality of these seats.

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