Now that the Premiers have boycotted Bob Hawke's New Federalism the debate of the decade is finally out in the open. Ever since the first special premiers conference was held in Brisbane last year the states have been working towards their financial revival. But with their income tax proposal rejected out of hand by the federal caucus in November, they must decide two things; firstly, is the 'reform' of federal-state relations an empty exercise without the return of broad-based taxing powers to the states? And will they return to negotiations with the Commonwealth in 1992 for a new deal on intergovernmental relations?

The answers to those questions will determine Australia's chances of becoming 'one economy' (along the lines of Europe's process of integration) before the centenary of its constitution in 10 years time. They also go to the heart of a fundamental political issue confronting Federal Labor's new federalism - the role of the states towards 2001.

From that first meeting in Brisbane, the phrase vertical fiscal imbalance (VFI) has become the 

\textit{bête noir} of the entire process. The VFI is a spending gap problem for the states created by the centralisation of taxing powers (the Commonwealth now raised around 70 per cent of total taxation and is responsible for 50 per cent of total public sector outlays). The states finance the balance of public expenditure through a range of narrow-based taxes (including financial and property turnover taxes and payroll tax) which tend to shrink along with economic activity, and Commonwealth government grants.

The VFI 'problem' as perceived by the states and the Commonwealth Treasury (a historic alliance) is that the states spend '50 cent dollars'. Their thesis is that because the Commonwealth hands out 40% of the states' income they lack responsibility and accountability in its distribution. This brand of economic rationalism concludes that giving the states access to broadly based taxation would improve their financial planning (by delivering more predictable revenues) and boost their incentive to cut waste (by providing opportunities for politically meaningful tax cuts).

But the macro-political agenda was considered too late in the framing of this equation. The subtext in a program of tax-decentralisation is power-devolution. And the man standing between federalist agendas and their implementation has always been the former federal treasurer, Paul Keating. His post-1985 strategy squeezed state revenues and borrowing flexibility to force economic efficiencies out of them.

The appointment of John Kerin as treasurer a few months ago signalled a fresh prospect to the states - the end of Keating's era of relentless centralism and a new dawn for the states' bid to regain some part of the fiscal sovereignty which they lost in 1942 when the Commonwealth took over income taxes as a 'temporary' war measure. The leadership challenge buried that hope.

The states lost the battle with federal caucus over their claim for income tax powers, but there are related issues still to be resolved. Does Mr Hawke now relish from the commitment made by his premiers conference communiques to place the fiscal imbalance high on the reform agenda? If not, then he has to get the states to return to the consultation process. But that will depend on the states' willingness to maintain the effective pace of their micro-economic reforms in return for some kind of revenue sharing agreement which may well fall short of the one they had in mind.

The problem is that federal caucus was too quick to dismiss the question of whether VFI matters or not. That debate will now be left to others like the Evatt Research Centre in Sydney which has already started work on a new edition of its comprehensive review of federal/state financial relations, \textit{State of Siege}. A recent review of the book's first edition by Christopher Shell, an economist with the West Australian Government takes on a particular relevance in the context of the New Federalism debacle.

According to Shell, \textit{State of Siege} "is remarkable as a significant departure from the modern labour view that states should be eliminated in favour of a national government with unfettered responsibility for economic development, employment and social security, supplemented by strengthened, more participatory, non-sovereign local administrations."

Since the book was released the prime minister has initiated a complete review of Commonwealth-State relations. The achievements described by Shiel include the reform of premiers' conference arrangements; public infrastructure investment such as the National Rail Freight Corporation; and wide-scale, systematic micro-reform of state functions. All are fundamental to the smoother economic running of the nation. But the political structure of the federation in relation to the role of the states (and their taxing powers) is unresolved in the wake of the cancellation of the November special premiers conference.

The states say they are being eliminated in practical political terms by fiscal attrition. As the debates surrounding constitutional reform and republicanism gather momentum the labour movement has to decide once and for all if this is true, and if so, whether it's a good or a bad thing.

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