# AUSTRALIAN FEDERALISM, TRANSPORT REGULATION AND THE TASMANIAN FREIGHT EQUALISATION SCHEME

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*ABSTRACT:* *The main purpose of this paper is to draw attention to some aspects of the regulation of interstate transport in Australia by focussing attention on the Tasmanian Freight Equalisation Scheme. Emphasis is given to one of the main objectives of the Australian Federation viz., the creation of a customs union for which an economically efficient transport system is an essential part. The paper outlines the Constitutional framework within which regulation of transport in Australia occurs, and gives some relevant historical background to establish the objectives of the federation. This is followed by an examination of the Tasmanian Freight Equalisation Scheme. The paper explains why regulations, by means of compensation payments, of interstate shipping services between Tasmania and the mainland are justifiable on second-best grounds, the relevant constraints being the Navigation Act, the Customs (Prohibited Imports) Regulations, and government pricing of rail services and road infrastructure.*

## 1. INTRODUCTION

Government regulation of transport is a feature of all developed economies but varying in form and extent. The issue of whether particular regulations are "good" or "bad" is often a complex one depending on the objectives which regulation is intended to achieve, the costs and benefits of existing and alternative policies, and the presence of constraints, including those set by the institutional and constitutional environment within which transport policy is formulated, and by government policies or regulations in related sectors of the economy.

It is the purpose of this paper to address some of the above issues in the context of transport policy in Australia. In particular, attention is focussed on the rationale for the provision of subsidies by the Federal government for shipping services between Tasmania and the mainland, such subsidies being provided under the terms of The Tasmanian Freight Equalisation Scheme (TFES).

This aspect of Federal government regulation of interstate transport is of special interest because one of the main reasons for the formation of the Australian federation was to create a customs union or free trade area between the member States, and that transport policies have an important bearing on the extent to which this objective can be achieved.

Section 2 of this paper provides a brief historical account of the background to the formation of the Australian federation and draws attention to the importance of the customs union concept to the Founding Fathers. In Section 3 an outline is provided of those parts of the Australian Constitution which establish the framework within which regulation of interstate transport must operate. The discussion in Section 4 focuses on Tasmania's so-called interstate freight cost disadvantage and the TFES - a subsidy program - which was introduced by the Federal government in 1976 to alleviate the perceived disadvantage. The Inter-State Commission's analysis of the TFES, and in particular, the argument that subsidy payments for some shipping services between Tasmania and the mainland can be justified on efficiency grounds by invoking the theory of second-best, is examined in Section 5. The discussion in Section 6 draws attention to some of the criticisms of a freight equalisation scheme and outlines the ISC's recommendations for a Tasmanian Freight Compensation Scheme (TFCS). A concluding statement is provided in Section 7.

## 2. THE FEDERAL MOVEMENT: AN HISTORICAL BACKGROUND

Among the various concerns which led the Australian colonies to form a federation, the potential economic gains from a customs union were of paramount importance. In fact, an attempt to achieve reciprocal free trade between the colonies of New South Wales, Van Diemen's Land and New Zealand occurred as early as 1842. Up until that time:

> All the colonies imposed import duties for purposes of revenue; and as trade developed, these duties began to wear a protective aspect. For many years after the separation of Van Diemen's Land it was the practice in New South Wales --

> contrary to the strict letter of the law -- to admit imports from Van Diemen's Land free, though levying duties on similar goods from elsewhere; whilst Van Diemen's Land reciprocated by inserting in her Customs Duties Acts an exemption in favour of imports from New South Wales. The separation of New Zealand made the need for intercolonial free trade more apparent; and in 1842 the Legislative Council passed an Act to permit goods the produce or manufacture of New Zealand or Van Diemen's Land to be imported free of duty. (Quick and Garran, 1901, p. 79)

This early attempt to promote intercolonial free trade among the three colonies was prevented by the Secretary for the Colonies on the grounds that it impinged on British commercial and foreign relations policies, and further, that a system of differential duties would lead to retaliation and protection. (Quick and Garran, 1901, p. 80) A consequence of this decision was that trade barriers between the colonies were allowed to develop and the differences in the fiscal policies of the colonies were gradually widened.

Recognising the undesirable consequences of such events, Governor Fitzroy (apparently at the suggestion of his Colonial Secretary, Deas-Thomson) recommended in a dispatch to the Colonial Office, in 1846, the appointment of some superior official "...to whom all measures adopted by the local Legislatures, affecting the general interests of the mother country, the Australian colonies, or their intercolonial trade, should be submitted by the officers administering the several Governments, before their own assent is given to them". (Quick and Garran, 1901, p. 80)

This initial suggestion of a federal union of the Australasian colonies was taken up by Earl Grey, Secretary of State for the Colonies, when, in 1847, he gave notice of his Government's intention to introduce a Bill establishing the colony of Victoria. According to Quick and Garran (p. 81) Grey produced the first written account of the case for Australian Union. Among other things, he considered that since the colonies had many interests in common, regulation of such interests by a single authority may be necessary for the common good. And further, that:

> Some method will also be devised for enabling the various legislatures of the several Australian colonies to co-operate with each other in the enactment of such laws as may be necessary for regulating the interests common to those possessions collectively, such, for example, as the imposition of duties of import and export, the conveyance of letters, and the formation of roads, railways, or other internal communications traversing any two or more of such colonies...." (Quick and Garran, 1901, p. 81)

Suffice it to say that Grey's suggestions for constitutional change were not accepted by the colonies who were indignant at not having been consulted, even though the concept of a common congress was not unpopular. (Cramp, 1913, p. 124)

Later, in 1849, the constitutional issues were the subject of consideration by a Committee of the Privy Council, the Committee on Trade and Plantations. The Committee recognised the importance of the abolition of customs duties between the colonies and the establishment of a uniform tariff. It was proposed that one of the Governors of the Australian colonies should be commissioned as Governor-General of Australia, and given the power to convene a General Assembly, consisting of the Governor-General and a House of Delegates whose members would be elected by the legislatures of the various colonies. It was proposed that the General Assembly should have, inter alia, legislative authority over such matters as: the imposition of duties on imports and exports, intercolonial roads, canals and railways, shipping dues, letter conveyance, weights and measures, and other matters referred to the General Assembly by the colonial Parliaments, and to raise funds by appropriating a percentage of revenue received by each of the colonies. No consideration was given to matters relating to defence.

Following the Committee's report a "Bill for the Better Government of the Australian Colonies" was introduced to the Parliament in 1849, and provided, not only for the separation of Victoria, the creation of a General Assembly in accordance with the report's recommendations, but also prescribed, and detailed in a schedule, a uniform tariff for the four colonies of New South Wales, Victoria, South Australia and Van Diemen's Land. (Quick and Garran, 1901, p. 86) However, the "federal clauses" were subject to considerable criticism both within Australia and England, and led to their removal before the Bill became law.

It has been suggested that Grey's attempt to impose a partial union on the colonies failed largely because the proposals had not originated from the colonies. (see, for example, Quick and Garran, pp. 88-89 and Cramp, pp. 126-127) Subsequently, proposals of a federal character were initiated by colonial statesmen. Thus, in 1853, a Committee of the New South Wales Legislative Council which had been established by Wentworth for the purpose of drafting a new Constitution, recommended the establishment of a General Assembly to deal with intercolonial matters, such as tariffs, roads, railways and postal services. This proposal, however, was not intended to achieve "real national unity", but instead, uniform legislation on some matters of common concern. (Quick and Garran, 1901, p. 91) A Constitutional Committee appointed in Victoria in September 1853, to draft a new Constitution for that colony, also argued for the need to establish a General Assembly to deal with questions of intercolonial interests.

During 1857 Select Committees were appointed by the colonies of Victoria, New South Wales and South Australia to address the issues of federal union. The Victorian Committee recommended a conference of delegates from each of the Colonial Legislatures, to discuss these matters. However, the conference failed to eventuate largely because of the obstacle of provincialism: "Local politics, and the development of local institutions, engrossed the attention of the people; and probably no colony would have been prepared to accept the compromises and the partial sacrifice of local independence which a federal union would have involved." (Quick and Garran, 1901, pp. 99-100)

While the achievement of complete federation required the resolution of many issues, the tariff question was, as already observed, of fundamental importance; and indeed, was the subject of discussion at several Intercolonial Conferences held between 1855 and 1880. Apart from early discussions concerning border treaties e.g. those relating to Murray river traffic, the uniform tariff question was to become the dominant issue. In 1868, Lord Buckingham, the Secretary of State for the Colonies stated:

> ...that the Home Government would gladly aid the establishment of a Customs Union embracing all the adjacent colonies, and providing for a uniform tariff, intercolonial free trade, and an equal division of the customs duties....; but they could not propose the repeal of the clause which prevented differential duties. (Quick and Garran, pp. 104-105)

Subsequently, the New Zealand Government proposed an Intercolonial Conference to examine the Customs Union issue. The proposal was renewed by Tasmania in 1870 and a Conference was then held between representatives from New South Wales, Victoria, South Australia and Tasmania. However, the uniform tariff was a major hindrance to progress. While all the colonies agreed to the need for a uniform tariff it was not possible to reconcile the fiscal policies of New South Wales and Victoria. The unwillingness of the Home Government to allow differential duties was also a difficulty. As events transpired the Home Country yielded on the differential tariff issue in 1873, but the resolution of the uniform tariff question was not to occur until much later. The differences in the fiscal policies of New South Wales and Victoria were a result of differences in their response to the employment situation following the depletion of the most productive gold reserves during the 1860's. Victoria became strongly protectionist, while the New South Wales government relied more on revenue from land sales and from income taxes than Victoria did, and was less cautious in financing expenditures by borrowing overseas. (Anderson and Garnaut, 1987, p. 41)

In 1881 another attempt was made to deal with the broader issue of establishing some form of federation. A proposal by Sir Henry Parkes for the setting up of a Federal Council was considered by representatives from New South Wales, Victoria and South Australia at meetings held in Sydney and Melbourne. Again, free trade New South Wales and protectionist Victoria were unable to reach a compromise on fiscal matters, and the proposal was rejected.

However, events on the international scene, such as the transportation of French criminals to New Caledonia and German activity in New Guinea, were to enter as a new dimension to the federalism-customs union debate, and by 1890 public enthusiasm for the concept of a federal union had reached an all time high. Thus, in 1891 a Convention of forty five delegates, seven from each Australian colony and three from New Zealand met in Sydney to draft a Constitution in which the essential ingredients of a federal union were established, including, inter alia, intercolonial free trade, federal defence, a federal tariff, and assurances regarding provincial rights in issues of provincial concern.

The Convention's recommendation that the proposed Constitution be submitted to a referendum failed, for a variety of reasons, to eventuate. However, "[the] failure of 1891 was but to be the prelude to complete success". (Cramp, p. 140) Further Conventions were held during 1897-8, and a substantially modified version of the 1891 Constitution which, among other matters, made provision for financial relations between the Federal government and the States, was finally accepted in a second referendum in 1889. Western Australia, which had not participated in the 1889 referendum, voted on the issue in July, 1900 and the new federation was established by Royal proclamation on the first day of the new century.

## 3. THE CONSTITUTION AND TRANSPORT REGULATION

The customs union concept, which was fundamental to the creation of the Australian federation, has implications for a number of areas of economic policy, not the least of which concern government involvement in the transport sector. Transport issues were important to the founders of the Australian Federation, as indeed they have been in the formation of the Canadian Confederation, the European Economic Community (Stabenow, 1974) and of other federations. In the case of Canada the promise of subsidised transport services was a condition for the entrance of some of the Provinces into the Confederation. Specifically:

> When the scattered colonies in British North America began seriously to consider forming themselves into a larger and stronger unit, they realised that cheap, reliable year-round transportation was essential if they were to be effectively bound together socially, politically, and economically. Consequently, the promise of railway construction formed an integral part of the Confederation scheme of 1867. Transportation was also important later when Prince Edward Island, British Columbia, and Newfoundland entered the Dominion. The obligation to the Maritime Provinces was acted upon by building, entirely at public cost, the Intercolonial and the Prince Edward Island Railway and ferry, and by not requiring that the rate level be high enough to cover fully the interest on the public's investment. The terms of union between British Columbia and the new Dominion were fulfilled [in part] by constructing the Canadian Pacific Railway. (Currie, 1976, p. 4)

In Australia such arrangements were not part of the Federal compact; but Tasmania has consistently argued since Federation that it suffers an interstate transport disadvantage because of its need to rely on sea transport.

There are a number of sections of the Australian Constitution which are of relevance to transport regulation and which reflect the importance which the Founding Fathers attached to the customs union concept and its implications for transport policy. Only those which have a significant impact on resource use are referred to here. It is also important to note that while a great deal has been written on each of these sections in isolation they are in fact interdependent. (Docwra and Kolsen, 1983)

Section 92 of the Constitution is of crucial importance to the customs union concept. The relevant part of this Section states: "...trade, commerce, and intercourse among the States, whether by means of internal carriage or ocean navigation, shall be absolutely free." The meaning of "absolutely free" has been the subject of a great deal of controversy and litigation. So far as the Founding Fathers are concerned it was their wish not only to abolish border duties and internal tariffs, but to create a free trade area within which people and goods could move, ignoring State boundaries, and without impediment by State or Federal governments. (see Joske, 1971, p. 167)

It is beyond the scope of this paper to attempt a detailed review of the High Court's interpretation of Section 92. Suffice it to say that in one area of interest in this paper - the regulation of interstate road transport - the High Court determined in Hughes & Vale v. N.S.W. (No. 2) (1955) 93 CLR 127) that taxes on interstate road transport may only be imposed for the purpose of recovering actual road maintenance costs. This decision overturned previous judgements which effectively allowed State governments to impose taxes on interstate road transport for the purpose of protecting railway interests. As discussed elsewhere (see, for example, ISC, 1985) the current interpretation has implications for road cost recovery policies, and efficiency in resource use. In this regard it should also be noted that in addressing the road tax issue the Court did so without reference to the pricing policies for interstate rail service; a consequence of which is that State rail authorities "adapted" to the Court's 1955 decision on interstate road charges by subsidising interstate rail services. (Kolsen, 1983) Although the Founding Fathers could not be expected to anticipate the complexities of the transport issues that would emerge during the Twentieth Century, there is clearly a difference between their view of the objective of Section 92 and interstate transport policy in practice.

While the objective of Section 92 is to prevent impediments to trade between the States, Section 51 states, inter alia:

> "That the Parliament shall, subject to this Constitution, have power to make laws for the peace, order, and good government of the Commonwealth with respect to - (i) Trade and commerce with other countries, and among the States;..." Here it is important to note that while the Federal government has the power to regulate interstate trade, and thus interstate transport, it cannot, according to Section 92, adopt policies which will prevent trade between the States from being "absolutely free". Thus it is not regulation per se which is prevented by Section 92. Instead it is regulation which directly and immediately impedes such trade. In a judgement in 1949 the Privy Council argued that regulation of interstate trade is compatible with "absolute" freedom; and that Section 92 is offended only if the effect of a legislative or executive act is "...to restrict such trade and commerce and intercourse directly and immediately as distinct from creating some indirect or consequential impediments which may fairly be regarded as remote". (Commonwealth v. the Bank of N.S.W., (1949) 79 CLR 639 (P.C.) The problem of course is to determine where the line is to be drawn.

Ihe concern of the Founding Fathers for matters relating to interstate trade and commerce and the development of Australia as an economic unit is also manifest by the provisions in the Constitution regarding the establishment and functions of an Inter-State Commission. The provisions referred to are Sections 101 to 104.

Section 101 states: "There shall be an Inter-State Commission, with such powers of adjudication and administration as the Parliament deems necessary for the execution and maintenance, within the Commonwealth, of the provisions of this Constitution relating to trade and commerce, and of all laws made thereunder." Specific reference is made to railways in Sections 102 and 104. Section 102 allows the Federal Parliament when enacting legislation with respect to interstate trade and commerce, to prevent, so far as railways are concerned, any preference or discrimination by a State or State government authority which in the view of the ISC is "unjust" or "unreasonable" to any State.

Section 104 provides additional instructions concerning the ISC's oversight of railway rates: "Nothing in this Constitution shall render unlawful any rate for the carriage of goods upon a railway, the property of a State, if the rate is deemed by the Inter-State Commission to be necessary for the development of the territory of the State, and if the rate applies equally to goods within the State and to goods passing into the State from other States".

While Section 101 makes no specific reference to transport it is obviously linked to other sections of the Constitution, including Section 98 which states: "The power of the Parliament to make laws with respect to trade and commerce extends to navigation and shipping, and to railways the property of any State". That the Constitution makes no reference to other modes of transport is not surprising, since at the time of Federation these were the only modes of importance for interstate trade. However, given that the above provisions were intended to achieve the objective of a customs union, it seems reasonable to suggest that Section 101 encompasses all matters concerned with freedom of trade within Australia, and all transport modes, including those of the future.

There are other provisions of the Constitution concerned with government intervention in the trade and commerce area. Thus Section 99 states: "The Commonwealth shall not by any law or regulation of trade, commerce, or revenue, give preference to one State or any part therefore over another State or any part thereof." Further, under Sections 51 (ii) and (iii), the Commonwealth has power to make laws with respect to: "(ii) Iaxation; but so as not to discriminate between States or parts of States; (iii) Bounties on the production or export of goods, but so that bounties shall be uniform throughout the Commonwealth."

Viewed as a whole the various trade and commerce provisions show that the Constitution was intended to prevent State government impediments to interstate trade and commerce (Section 92), and to subject Federal government regulation of interstate trade and commerce to the test of Section 92, and the requirement that there be no discrimination between States or parts of States. In economic terms this means that the above provisions of the Constitution have, as an objective, the prevention of arbitrary impediments to the movement of goods and people within

Australia. However, in practice the constitutional framework which has emerged does not entirely match the intentions of the Founding Fathers. State parochial interests are still important and the Federal government has not made full use of the powers assigned to it, especially those under Section 51.

## 4. REGULATION OF INTERSTATE TRANSPORT: THE TASMANIAN FREIGHT EQUALISATION SCHEME

One of the implications of the customs union concept for the efficient use of resources in the transport sector is that the prices of transport services should reflect the resource cost of providing such services, including relevant infrastructure costs. In view of the Constitutional requirements regarding interstate trade and commerce it is of some interest to focus attention on government regulation of interstate transport which might appear to be inconsistent with the customs union or free trade concept. One such area of Federal government policy is the provision of subsidies for shipping services between Tasmania and the mainland.

As noted earlier, one of the issues of concern to the colonies in the pre-federation debates was that the States in general would have adequate revenues, and that there would be safeguards against financial hardship of particular States. The so-called 'Small States' were especially concerned about the effects of a federal tariff on their economic development and their revenue base. Various provisions were included in the Constitution to meet these revenue concerns, and in the 1930's the Grants Commission was established in further recognition of the financial requirements of such States. (see, for example, May 1971)

For Tasmania the problems associated with the provision of shipping services was also to become a matter of concern, commencing during the early days of federation through to the present time. In essence, successive Tasmanian governments have held to the view that Tasmania is placed at a disadvantage vis-a-vis the mainland States because of the need to rely almost entirely on shipping services for the transport of goods to and from the mainland. In part this "disadvantage" has been attributed to Federal government policy as manifest by the various Navigation Acts which have as a major objective the development of a mercantile service. Thus, for example, in a 1925 Report which examined the 'disabilities' of federation for Tasmania, it was stated:

> Tasmania, then, is suffering from serious loss of shipping facilities, both for cargo and for passengers, and from an excessive rise in interstate freights, and her position and trade (including tourist traffic) make her susceptible to injury on these accounts to a very much greater degree than any other State. It is not suggested that all these disabilities are due directly or indirectly to the Navigation Act. But the Navigation Act and the policy which it embodies are undoubtedly a serious aggravation of the trouble. Services have been cut down or discontinued, and interstate charges have been greatly increased in most cases as the natural and direct consequence of the increase in shipping costs -- an increase very much greater than in the case of

> overseas shipping. The Navigation Act is accepted as the expression of the policy of Australia to protect and encourage Australian shipping. Such protection and encouragement should be at the expense of Australia generally, but as the only shipping that it is possible to encourage is shipping within Commonwealth waters, and as Tasmania is in proportion to population much more deeply interested in such shipping than any other State, it follows that the cost falls very much more heavily on Tasmania than on any other State, and offers, in fact at present the most serious threat to her present and future solvency. (Tasmanian Disabilities Report, 1925, p. 8)

Since that time there have been a number of reports which have given attention to the Tasmanian shipping problem. (See for example, Nimmo Report, 1976) And the issue of financial assistance to meet interstate freight cost disadvantages, as perceived by Tasmanian shippers, has generally been viewed by Tasmanians as a matter for special financial consideration by the Federal government i.e., additional to matters normally considered by the Grants Commission.

The event which was ultimately to lead to the IFES was a decision by the Federal government to allow the Australian National Line (ANL) to increase non-bulk freight rates by 12.5 per cent on its Tasmanian services, with effect from 1 August 1970. The controversy that developed from this decision was such that the Senate referred the matter to its Standing Committee on Primary and Secondary Industry and Trade. It was the Committee's conclusion that, while the increase in freight rates was fully justified, Tasmania was placed at a disadvantage relative to other States in terms of freight costs. It also concluded that the inherent inflexibility of shipping placed Tasmania at a disadvantage in the absence of alternative transport modes. (Senate Standing Committee, 1971, pp. 28 and 36)

In October, 1971 the Minister for Shipping and Transport referred the issue to the Bureau of Transport Economics (BIE). The BTE presented its findings in 1973 (BIE, 1973) which included a quantitative assessment of the disadvantage by comparing shipping freight rates per tonne for shippers of goods between Tasmania and the mainland with estimates of road and rail freight rates for a hypothetical road and rail link between Melbourne and Devonport. The disadvantage was shown to be inversely related to the density of the commodity transported.

The BIE's investigation also showed that so far as the shipping of bulk cargoes is concerned, Tasmania's problems were no different from those experienced in the shipping of such goods between mainland ports. Various suggestions were made by the BIE for the purpose of achieving reductions in sea transport freight rates. These included: use of more efficient vessels; elimination of the sea passenger service; the establishment of a central authority to plan and control development of Tasmanian ports, and the reduction of imbalances resulting from the number of freight forwarders and the consequent large number of depots. (BIE, 1973, p. ix)

After consideration of the BIE's report, and spurred on by continuing criticism of freight rate increases, the Federal Government announced, in April 1974, the establishment of a Commission of Enquiry - consisting

of one person, Mr J.F. Nimmo - to report on the existence, extent and principal causes 'of any differences between the level of charges for the transport of persons and goods between places in Tasmania and places on the mainland of Australia and the level of charges for the transport of persons and goods between places on the mainland of Australia'. (Nimmo Report, 1976, p. 1) The Commission was also instructed to examine and report on 'the effects of any such differences on particular industries in Tasmania....' and to recommend 'any measures that might be taken to reduce or eliminate any such differences that might have an adverse effect for Tasmania....' Further, in making such recommendations the Commission was directed 'to take account of any disadvantages which Tasmanian industries may suffer in relation to transport because of their physical separation from the mainland of Australia, having regard, however, to any advantages that industries may enjoy by location in Tasmania....' (Nimmo Report, p. 1)

The Commission reported its findings in March 1976. Tasmania's transport cost disadvantage was assessed by comparing the door-to-door charges for transporting goods by sea routes from Tasmania to the mainland with transport charges for similar goods on 'comparable' mainland rail and road routes. The Commission argued that the principal cause of Tasmania's transport cost disadvantage, for most non-bulk goods, is the physical separation of Tasmania from the mainland, and that a case can be made for the provision of financial assistance to offset this disadvantage on the grounds that 'Tasmania is a sovereign member of the Australian federation' and 'in federating, the States in effect agreed to share their resources'. (Nimmo Report, p. 152)

In determining the amount of the subsidy payment, Commissioner Nimmo not only considered the above mentioned comparative cost disadvantage, but also took account of inventory cost differences. The freight cost disadvantage thus calculated, was then adjusted to allow for the notional natural advantage industries experienced by locating in Tasmania. The subsidy proposals did not apply to imported consumer commodities since it was found that many producers of such goods adopted a price equalisation policy in some or all of the mainland and Tasmanian capital city markets. Bulk commodities were also excluded from subsidy assistance; it was the opinion of many of the Tasmanian shippers interviewed by Commissioner Nimmo that they were not placed at a disadvantage relative to mainland residents with regard to the interstate movement of such goods in bulk ships. Thus, the northbound scheme applied to non bulk cargoes shipped between Tasmania and the mainland, whereas for southbound traffic (the southbound scheme), subsidies were to be applied only to raw materials and equipment transported as non-bulk cargoes. The Commissioner also recommended financial assistance for the movement of goods by air transport, even though it was found that Tasmanians did not experience a disadvantage with respect to such traffic.

With regard to the payment of the subsidies Commissioner Nimmo recommended that assistance should be made directly to the persons and firms identified as experiencing the financial disadvantage. The rates of payment were stated in terms of dollars per tonne or cubic metres or, in the case of livestock, in terms of dollars per head. The proposed schedule covered 46 commodities on six routes.

The Federal Government accepted most of the recommendations made by Commissioner Nimmo, and the TFES came into being on 9 June 1976. In determining the rates of assistance the Government adopted a policy of full freight equalisation, thereby excluding reductions made by Commissioner Nimmo to take cognizance of any advantages that industries received by location in Tasmania. The Government also rejected the recommendations concerning assistance to air freight.

A review of northbound and southbound rates of assistance was undertaken, respectively, by the BTE in 1978 and 1979. Following reservations expressed by the BTE about the Nimmo method for calculating subsidies the Government directed the BTE to undertake further investigations of the costs incurred by industries utilising long distance transport between mainland States. The BTE reported its findings in 1981. (BTE, 1981) The report discussed alternative ways of overcoming the weaknesses of the Nimmo approach, in particular the difficulties associated with the use of four different mainland routes as a basis for determining subsidy payments. (BTE, 1981, pp. xi, xii) The BTE's approach estimated freight rates using regression analysis, including an estimation of rates based on the equivalent road distance from Tasmania to Melbourne (the "landbridge" approach). The method was subject to considerable criticism, mainly because of the magnitude of the changes in subsidy rates which it produced. (see for example, ISC, 1985, p. 145)

Further analysis and recalculation of rates of assistance were undertaken by the BTE in 1981, using the Nimmo method and variations of the landbridge approach. In 1982, the rates were again recalculated, this time on the basis of the Nimmo method. Neither the landbridge nor Nimmo methodologies provided an acceptable basis for updating the rates of assistance. Accordingly, in March 1984 the Federal government referred the matter to the ISC for consideration. For the period 1983-84 rates of assistance for the northbound scheme amounted to $27,460,000 and for the southbound scheme, $1,868,000.

## 5. THE INTER-STATE COMMISSION'S ANALYSIS

The first ISC was created by an Act of Parliament in 1912 and operated for the period 1913-1920. For various reasons the ISC was not to re-appear on the Australian scene until many years later. The resurrection of the ISC was initiated by the Whitlam labor government by an Act of Parliament in October, 1975. However, it was not until the return of the Labor Party to power in 1983 that the Act was put into operation. The first two Commissioners were appointed on 15 March, 1984 - the same day that the Minister for Transport referred the TFES issue to the ISC.

The terms of reference required the ISC to 'investigate matters relating to the Scheme and in particular to consider:

(1) (a) The extent to which freight equalisation payments made under the existing Scheme provide appropriate compensation for any interstate freight cost disadvantages,

(b) whether, in the interests of economic efficiency and equity, any changes are desirable to the form of such compensation.

(2) In the event that the Commission considers that changes should be made to the Scheme, the Commission shall investigate alternatives and consider:

(a) the appropriate levels of freight cost equalisation payments that should be paid and their expected cost;

(b) the method of calculating the levels of payment; and

(c) the appropriate mechanisms of administration including arrangements for adjusting the rates of equalisation payments in the future.' (ISC, 1985, pp. 39-40)

It is important to note that the ISC's terms of reference are fundamentally different from the terms of reference to the Nimmo investigation. This is highlighted, in particular, by the use of the term 'economic efficiency' in (1)(b) of the ISC's terms of reference and the absence of that concept in the terms of reference of the Nimmo Commission. Indeed, the ISC sought legal advice on the interpretation of its terms of reference and on the basis of such advice argued that the Nimmo Commission was constrained to develop a 'freight equalisation' scheme. As stated by a former Minister for Transport:

> The equalisation scheme is designed to provide that the cost of transporting goods between Tasmania and the mainland is approximately the same as moving similar goods by land across the same distance on the mainland.
>
> Essentially it is designed to remove the transport disability Tasmania suffers by reason of its separation by sea from the other States of the Commonwealth. (cited by ISC, 1985, p. 47)

In contrast the ISC's terms of reference enabled the Commission to adopt a different approach by virtue of the reference to 'economic efficiency and equity'.

The Commission also sought legal advice on the question of whether the TFES was contrary to Section 99 of the Constitution, a matter which was raised by a number of witnesses. For example, it was stated in a submission of the Queensland Committee of Fruit Marketing that:

> In view of the equity considerations outlined earlier in the submission, Queensland fruit and vegetable growers believe that the TFES...sits rather awkwardly in relation to the principle of free competition amongst the States.
>
> It is recognised that the question of whether or not the IFES is constitutionally valid is an involved legal one. However, such factors as the amount of the freight rebates available under the Scheme and the conclusions of the BTE (Bureau of Transport Economics) that the subsidies to distant destinations are greater than required for equalisation,

> suggest that the TFES creates a preference and, is therefore in contravention of the Australian Constitution. (cited by ISC, 1985, p. 58)

In accord with the legal advice received, the ISC noted that Section 99 applied only to laws or regulations made under Section 51(i) of the Constitution. The TFES is implemented by executive and administrative means and funded as an item in the Appropriation Act. The power of the Parliament to make such appropriations is conferred by Section 81 which states 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....

Thus, according to legal opinion, the Appropriation Act does not constitute a law or regulation of trade or commerce within the meaning of Section 99. (ISC, 1985, p. 59) Further, the ISC considered that it was unnecessary to determine if the TFES were a 'law or regulation of trade [or] commerce' within Section 99, it would constitute the giving of a 'preference'. (ISC, 1985, p. 59) No attempt is made here to pursue these matters further, except to say that to the economist, subsidy payments are a form of economic regulation, and that such payments made under the Appropriation Act might not survive constitutional challenge if made under some other law or regulation.

The centre piece of the ISC's approach to its examination of the TFES is the application of the concept of economic efficiency, in particular, as required in terms of the theory of second-best.

As already mentioned, an implication of the free trade or customs union concept for an efficient use of transport resources is that the prices of alternative transport services should, in the absence of externalities, systematically reflect relevant resource costs. Under such circumstances each transport mode will specialise in providing those services in which it has a comparative advantage. This is the so-called 'first-best' outcome. However, when the prices of some transport services do not reflect relevant costs (e.g., because of taxes, subsidies or market conditions), and such prices have to be accepted as a constraint, the economic efficiency objective requires adjustments to the prices of competing and/or complementary services. The appropriate adjustments are referred to as 'second-best' policies.

So far as the TFES is concerned the ISC argued that '....differences in location, like differences in fertility of land, climate and topography, do not as such provide valid reasons for arguments for compensation based on economic efficiency'. (ISC, 1985, p. 68) To argue that Tasmania suffers a transport disadvantage because it is separated from the mainland, and accordingly is forced to rely on shipping services, is in principle no different from arguing that producers of bulk commodities in Mt Isa are placed at a disadvantage because there is no inland sea by which they can transport such goods. Such arguments lead to absurd policy recommendations.

While geographical factors as such could not be used as an economic efficiency argument for subsidising interstate trade between Tasmania and the mainland, the ISC argued that compensation payments could be justified on second-best grounds. Attention was drawn to a number of government policies which cause '...deviations of costs and freight rates from the levels at which they would otherwise be in sea, rail and road transport...' (ISC, 1985, p. 67) It was argued that '[if] the effects of such policies, as the unintended by-products of the achievement of other objectives, [e.g. equity and other public interest objectives], put those who transport goods to and from Tasmania at a disadvantage compared with those who transport goods between places on the mainland, there is a clear case for compensating those who transport goods to and from Tasmania'. (ISC, 1985, pp. 67-68)

The policies identified by the Commission which, seen as constraining factors, provide an economic basis for compensation, are: (a) The Navigation Act 1912 (Cth), (b) the Customs (Prohibited Imports) Regulations, and (c) government pricing of rail services and road infrastructure.

The effect of the regulations under (a) and (b) was to increase shipping costs for all users of coastal shipping services. In brief, the Navigation Act effectively prevented foreign ships from competing with Australian ships for coastal trade, while under the Customs (Prohibited Imports) Regulations ships were prohibited imports unless ministerial consent was obtained. Although there have been some changes in ship imports policy in 1987, at the time of the ISC's investigation ship imports policy did not allow the permanent importation of second hand vessels between 70 and 10,000 gross construction tonnes and of a type available from Australian shipyards. Temporary importation of such vessels may be authorised if a commitment was given to have a replacement ship constructed in Australia. As noted by the ISC most of the vessels transporting cargoes across Bass Strait fell within the 70 to 10,000 gross construction tonnes range. (ISC, 1985, p. 70)

In essence, this aspect of the Commission's argument states that it is not the use of sea transport as such which contributes to some of the difficulties faced by shippers of goods to and from Tasmania; but instead, the existence of Federal government policies which require the use of shipping services which are expensive by international standards. Thus, a disadvantage is created as an 'unintended by-product' of policies designed to create a merchant marine service and a local ship building industry.

As explained by the Commission, such a problem is not unique to Australia. In the United States, coastal shipping services have been reserved for American shipping since 1808. Moreover, the regulation has been extended to the intercoastal trade and trade between non-contiguous areas, such as Hawaii, Alaska and Puerto Rico. The residents of such areas have complained that the requirement to use high-cost American shipping places them at a disadvantage. In the case of Puerto Rico it was maintained that either a subsidy be granted or that the residents be allowed to utilise the shipping services of low-cost foreign operators. In more detail:

> They feel they are being called upon to bear the expense of a merchant marine that is intended not for their special benefit but for the general advantage of the United States, with special emphasis on military preparedness. Why should this part of the cost of national defence be borne disproportionately by the inhabitants of the outlying possessions? The most satisfactory answer to these complaints, of course, would be to reduce the costs of American shipping to a level competitive with other maritime nations. But to the extent that such cost reductions are not possible, there is a real question whether the policy of subsidy should not be extended to the trades with non-contiguous areas. (Lansing, 1966, p. 349)

A more formal analysis of this and other aspects of the Commission's argument is developed by Harvey (1986). While accepting the argument that a subsidy payment is warranted on efficiency grounds, given the constraint of the Navigation Act, Harvey also notes that the case for a subsidy based on the effects of Federal government ship importation policy is less clear on a priori grounds. Consideration also needs to be given to the level of protection afforded to imports of inputs used by land transport modes, in comparison with the average level of protection for all imports. If it can be demonstrated that the level of protection on land transport inputs is less than the average for all imports, then '...a subsidy to shipping would, by reducing the importation of these inputs, improve the allocation of the nation's foreign exchange reserves among commodities imported'. (Harvey, 1986, p. 12) A reasonable assumption made by the Commission is that the levels of protection afforded to land transport inputs, especially those for rail inputs, are below the "average".

Apart from the direct effects of Federal government regulation in increasing the costs of providing coastal shipping services, there is also the possibility that freight charges paid by shippers may be subject to further increases because of the indirect effects of such regulations. Since the Navigation Act and Customs Regulations reduce the level of contestability in the coastal shipping industry 'this permits and even encourages some practices which would enable freight rates to be raised above the already high costs of supply including a reasonable rate of profit'. (ISC, 1985, p. 71) Given the oligopolistic structure of the coastal shipping industry, and the absence of competition from land transport in some markets, it is possible for the suppliers of shipping services to assign some of the joint costs of supply, such as port infrastructure, to the services provided in less competitive markets. By this means rates of return in the various markets can be made to appear "fair and reasonable".

While the Commission was unable to carry out the kind of investigation necessary to determine whether excessive profits are earned on the Bass Strait trade, it was prepared to argue that it is the sum of the direct and indirect consequences of Federal government regulation '...which is, to a very significant degree, responsible for freight rates which are very high when compared with freight rates available in the international shipping market'. (ISC, 1985, p. 71) Thus, both effects form part of the Commission's justification for subsidy payments. However, as pointed out by Harvey (1986, p. 9), there are

likely to be objections to the payment of subsidies to offset monopoly pricing policies, especially when the legislation under which the Australian National Line (ANL) operates, contains provisions intended to prevent excessive charges. The Commission did not examine this issue, but recommended that the ANL be required to publish separate accounts for its general cargo shipping services and that a Tasmanian Association of Interstate Shippers be established for the purpose of strengthening the bargaining position of shippers in their negotiations with shipping and other transport firms.

The issue of rail and road cost recovery policies also formed part of the Commission's application of the theory of second-best to the analysis of the Tasmanian interstate transport problem. In this regard the Commission was concerned with the effect of both State and Federal government policies which result in the subsidisation of some interstate land transport services.

So far as rail subsidies are concerned, the Commission referred to the National Road Freight Industry Inquiry (NRFII) report which stated that:

> The Inquiry is obliged to conclude that railway managements frequently price rail freight services so as to do no more than cover avoidable expenses (at best); and that in a significant number of cases, the prices are so low (relative to railway cost levels) that even this modest financial target is not met. In consequence, many joint and other costs are not recovered and large deficits ensue. (NRFII, 1984, p. 272)

The NRFII made specific reference to intercapital rail movements of freight forwarders' traffics and concluded that it was very doubtful whether the revenue from such traffics was adequate to meet even avoidable costs. (NRFII, 1984, p. 270-1) The ISC also drew attention to the fact that rail services in Tasmania are heavily subsidised, noting that in 1983-84 the Australian National (AN) advised that total working expenses of the Tasmanian part of AN's operations exceeded total revenue by $19.8 million.

With respect to the consequences of subsidised mainland rail services the ISC pointed out that shippers of goods to and from Tasmania are able to benefit from subsidised mainland rail charges to the extent to which they make use of rail services on the mainland part of the journey. However, they are placed at a comparative disadvantage '...because, unlike those who transport from mainland origins to mainland destinations, they must bear the cost of a segment of the journey which does not benefit from such a subsidy'. (ISC, 1985, p. 72) Further, the ISC considered that while subsidised rail services in Tasmania might offset some of the benefits enjoyed by users of mainland rail services, such effects are likely to be greatly restricted by the fairly short rail hauls available to shippers in Tasmania. (ISC, 1985, pp. 72-73)

On the matter of road cost recovery the ISC also referred to the NRFII report where some tentative estimates were provided of the extent to which articulated vehicles failed to meet maintenance and other costs which were attributable to their use of the roads. The ISC did not pursue this complex issue in its study of the IFES; it mentioned road infrastructure pricing policy to show that best available estimates of

road transport cost recovery ratios indicate a cross-subsidy to the type of vehicles which are typically engaged in interstate transport, and in competition with rail services. The cross-subsidy to road, however, was assessed as being significantly less than the subsidy provided to rail. Subsequent studies of the road and rail cost recovery issues by the ISC (1986 and 1987) provide further evidence concerning interstate rail and road cost recovery ratios.

In addition to the efficiency aspects of the case for subsidy payments to Tasmanian shippers, the ISC was required to give consideration to equity matters. This formed a small part of the ISC's analysis and is only mentioned briefly here. The Commission considered various notions of equity, but placed most importance on the notion that 'if recognisable groups of individuals experience a reduction in their income as an unintended consequence of policies pursued by governments, equity may require that the level of income of that group be restored to the level at which it would have been in the absence of that policy act'. (ISC, 1985, p. 77) As the ISC also noted, it was not the intention of government policy to lower the real incomes of shippers of goods to and from Tasmania when the Federal government introduced the Navigation Act and Customs Regulations, or for that matter when railway subsidies began to develop. (ISC, 1985, p. 75) Accordingly, the ISC saw no major conflict between the efficiency argument for compensating Bass Strait shippers and the equity consequences of such action. Some criticism of the ISC's approach to the equity issue has been raised by Harvey. (1986, p. 13) However, it is the efficiency argument which is the most important element in the ISC's analysis.

## 6. COMPENSATION OR FREIGHT RATE EQUALISATION?

Chapter 12 of the ISC's report provides, inter alia, a detailed critique of the IFES. Since the various transport modes have different technical characteristics they have different capabilities to provide transport services. One obvious demonstration of this is to be found in the different capabilities of ships and road transport to carry commodities of high and low density. In a competitive market environment these differences in inherent capabilities would be reflected in freight rate relativities for the transport of high and low density commodities by sea and road. For general cargo ships volume is at a premium, while for the land transport modes weight is normally the more important factor. As the ISC points out, attempts to compensate for differences in the physical capacities of the various modes inevitably results in economic inefficiencies. (ISC, 1985, p. 245) In addition there are many practical problems involved in attempts to achieve freight equalisation. This is highlighted, for example, by the existence of differences in the rates on forward and back legs of land transport journeys. Attempts at equalisation thus raise the question of which of the above rates to use on a particular trip, or whether to use an average rate. Further, such rates are subject to frequent variations in response to changes in demand conditions.

Since the objective of the ISC's analysis is fundamentally different from that of the Nimmo and BIE studies of Tasmania's interstate transport problem, the ISC preferred to call its scheme the Tasmanian Freight Compensation Scheme (TFCS). The purpose of this scheme is not

to attempt equalisation of freight rates, but instead to compensate for a disadvantage as an unintended by-product of government transport policies. The ISC's argument is that the interstate freight cost disadvantage (ISFCD) which is borne solely by shippers of general goods between Tasmania and the mainland and which cannot be avoided by using subsidised land transport modes, is that related to the shortest sea journey between Tasmania and the mainland. This reasoning gave rise to what the ISC calls the 'end at Melbourne' concept. The argument is that once goods from Tasmania are landed in Melbourne, no additional disadvantage exists. The choice of mode of transporting such goods to other mainland destinations is the same as that for like commodities transported between mainland origins and destinations. For this reason the ISC argued that higher levels of subsidy payments for longer routes could not be justified on efficiency grounds.

So far as southbound traffic is concerned the evidence received by the ISC, albeit minimal, on the subject of the equalisation of capital city prices was consistent with that produced by the Nimmo Commission. Accordingly, the ISC adopted the latter's recommendation that subsidies not be provided for southbound consumer goods. The ISC also accepted the view that cargoes destined for export markets not be subsidised given the existence of the cargo centralisation arrangements of shipping conferences.

The ISC's recommended rates of compensation were detailed in three schedules, namely, for high density commodities, for livestock and for non-specified commodities. Although the method of calculating the rates of compensation was not stated by the ISC the rates for high density commodities amount to approximately 33 1/3 per cent of the 1985 rates from northern Tasmania to Melbourne, and the unspecified commodity rates to about 60 per cent. The rates are provided for the different types of containers used in the trade, and rates per tonne, cubic metre or livestock (per head) were calculated for less than container loads. A mechanism was also provided for reducing the rates of compensation in the event that freight rates should fall.

As to the method employed for determining the level of compensation payments, the ISC did not carry out the kind of detailed empirical analysis which its theoretical framework would suggest. The approach included a number of matters of judgement. The fact that the recommended total compensation payment is not too different from that made under IFES may be a reflection of the ISC's political sensitivity rather than a consequence of empirical investigation.

However, of far greater importance is the fact that the ISC was able to provide an economic framework for dealing with the issue of Tasmania's interstate transport disadvantage. Such a framework provides a firm foundation for dealing with similar problems, existing or potential, in the area of interstate transport.

Although the Government rejected the arguments on which the new scheme was based it accepted and implemented all of the ISC's principal recommendations.

## 7. CONCLUDING REMARKS

This paper began by drawing attention to the importance of the customs union concept in the formation of the Australian Federation. Various sections of the Constitution of particular relevance to the development of Australia as an economic unit were noted. An examination of these provisions indicates that while governments can regulate interstate transport such regulation should be consistent with the requirement of Section 92 that "....trade, commerce, and intercourse among the States, whether by means of internal carriage or ocean navigation, shall be absolutely free". There are, however, ways in which governments have "adapted" to this requirement. For example, when the High Court ruled in 1955 that road taxes imposed by State governments on road transport vehicles engaged solely in interstate trade could only be related to road maintenance costs, the State governments accepted subsidisation of interstate rail operations in order to maintain rail's market share.

There is also evidence that in the road transport sector various vehicle types engaged in interstate and intrastate trade fail to meet the costs which they impose on the road system. The issue of road cost recovery is a complex one (see Kolsen and Docwra, 1987) and there is no consensus on the extent of the road subsidy. Estimates of cost recovery depend on the methodology employed to determine cost attribution (see ISC, 1986 and 1987), and on the definition of road user charges (ISC, 1986). Further, it is only in recent years that governments have given serious attention to these matters. A satisfactory outcome depends on a number of factors including the High Court's interpretation of Section 92 and on the willingness of the Federal and State governments to engage in co-operative action with respect to road charging and investment policies.

It is within this context, including Federal government regulations of coastal shipping that the issue of the TFES is addressed.

Since subsidies to shippers of goods between Tasmania and the mainland are a form of regulation of interstate transport the question arises as to whether subsidy payments can be justified on efficiency grounds and whether such payments might be seen to be in accord with the requirements of Section 92. Conveniently, the latter question was not examined since the TFES payments are made under an Appropriation Act, and as such, are apparently not subject to either Section 99 or Section 92.

As to the efficiency question the paper has highlighted the reasoning adopted by the ISC in its 1985 report. A central proposition is that Tasmania's geographical position, and hence its reliance on sea transport, does not provide an efficiency argument for subsidy payments to shippers of goods between Tasmania and the mainland. Rather, Tasmania's interstate transport disadvantage is a consequence of the unintended effects of a number of Federal and State government transport policies. By drawing on the theory of second-best the ISC argued that such policies, taken as constraints, provide an efficiency argument for compensating shippers of general cargoes between Tasmania and the mainland. By implication if road and rail services were priced in such a way as to meet resource costs, and if the coastal shipping trade were

highly contestable, compensation payments would not be warranted on efficiency grounds. The "first-best" outcome implied by the customs union concept would apply.

While the TFES is a relatively minor issue in matters concerning government regulation of transport, the ISC's analysis of that scheme draws attention to some of the problems involved in achieving an efficient transport system within the Australian federation. Moreover, the methodology adopted by the ISC provides a rigorous economic basis for dealing with other similar problems concerning the regulation of interstate transport.

ACKNOWLEDGEMENTS

I am indebted to my colleague Professor H.M. Kolsen for helpful advice and comments.

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