

**NEW SOUTH WALES GOVERNMENT SUBMISSION TO THE
SELECT COMMITTEE ON THE REFORM OF THE AUSTRALIAN FEDERATION**

Overview

The New South Wales Government welcomes the Committee's inquiry into issues and priorities for the reform of the three levels of Government within the Australian federation, as well as the exploration of a possible agenda for national reform and its implementation.

This submission has been drafted after consultation across New South Wales Government agencies to identify key issues that New South Wales seeks to bring to the Committee's attention.

The term 'States' is used in the submission in reference to both States and Territories.

The key issues raised by the New South Wales Government in this submission are:

1. Any proposal for constitutional reform of the division of powers and responsibilities between levels of government should be:
 - developed with the agreement of the relevant levels of government and informed by national community consultation;
 - framed narrowly to remedy problems for which there is no other reasonable solution; and
 - targeted at improving cooperative relations between the levels of government to optimise the standard of governance for Australia.
2. The Commonwealth should consider, in consultation with the States, opportunities to better balance revenue flows and spending responsibilities between the three levels of government as part of its further consideration of the recommendations of the Henry Tax Review.
3. The Commonwealth should commission, in consultation with the States, a thorough investigation of the impact on national welfare of Australia's system of Horizontal Fiscal Equalisation (HFE).
4. Any proposal for change to the Australian Constitution to recognise local government should take account of, or allow for:
 - existing provision in State constitutions regarding local government arrangements;
 - flexibility to restructure local government funding and reporting arrangements;
 - existing statutory provisions of State governments regarding shared functions, supervision and review of local government; and
 - sustainability of for local government.
5. The Council of Australian Governments (COAG) as an institution should be strengthened by a mechanism such as an Intergovernmental Agreement that underpins its operations.
6. Any consideration of the referral of powers should be considered on a case-by-case basis with thorough review and evaluation of alternative options.

7. The removal of barriers imposed by the Australian Constitution to ensure the most consistent and cohesive application of law nationally should also be considered.
8. To foster collaboration and deliver timely agreements, Intergovernmental Agreements (IGAs) should be negotiated and drafted in a manner which recognises States as sophisticated sovereign Governments in their own right.
9. Strategies to strengthen Australia's regions should foster collaborative arrangements and encourage long term approaches to planning and service delivery.

The following is high level commentary from the New South Wales Government addressing the Committee's Terms of Reference.

Key issues and priorities for the reform of relations between the three levels of government within the Australian federation

The New South Wales Government is aware of the increasing interest of the Australian people and government stakeholders in clarifying the varied roles of governments in the federal system. The New South Wales government supports more cost-effective government with clear responsibilities that avoid blame-shifting. Governmental roles should be settled so that policy and service delivery lie with the level of government with the greatest connection to the part of the community benefiting from the policy or service delivery.

The reforms to federal financial relations that have been pursued since 2008, particularly the Intergovernmental Agreement on Federal Financial Relations, have brought greater clarity of roles across shared policy areas. There remains however the fundamental issue of the large vertical fiscal imbalance between the Commonwealth and State governments in Australia, which produces the need for large financial transfer between these levels of government.

This vertical fiscal imbalance, coupled with the Commonwealth Government's movement into areas traditionally regarded as the preserve of States and Territories, are key issues to be considered in respect to reform of the relations between the governments within the federation. This submission will discuss these issues in more detail when addressing the specific Terms of Reference.

A possible agenda for national reform and its implementation

i) The distribution of constitutional powers and responsibilities between the Commonwealth and the States (including territories)

The Australian Constitution sets out the powers and responsibilities of the Commonwealth, with the States having responsibility for those residual matters that are not vested with the Commonwealth. This means that the States' powers and responsibilities are largely determined by omission from the Australian Constitution.

The absence of expressed areas of authority for the States, combined with the progressive concentration of legal authority and revenue raising power with the Commonwealth Government, has increasingly put the Commonwealth in a position to intervene in policies and services that are administered by the States.

From the perspective of New South Wales, this is an undesirable arrangement that opens the door to interventions into State policy by another level government that may be unaccountable for the consequences on services and budgets administered by the States.

However, there are cooperative remedies available that do not require, or require only minimal, change to the Australian Constitution.

The key issue for New South Wales of redressing the financial imbalance between the levels of government is addressed under Section ii) following, with examples and future options for reform dealt with in Section iv).

Powers and responsibilities of local government in New South Wales and the implications of recognition in the Australian Constitution are dealt with in Section iii).

Any proposal for constitutional reform of the division of powers and responsibilities between levels of government should be:

- developed with the agreement of the relevant levels of government and informed by national community consultation;
- framed narrowly to remedy problems for which there is no other reasonable solution; and
- targeted at improving cooperative relations between the levels of government to optimise the standard of governance for Australians.

ii) *Financial relations between federal, state and local governments*

The constitutional basis of Commonwealth-State financial relations

Australia's federal financial relations are marked by a high degree of vertical fiscal imbalance (VFI). VFI refers to the significant mismatch between the:

- States' large spending responsibilities but limited revenue capacity; and
- The Commonwealth Government's capacity to raise much more revenue than it requires for its own expenditure needs.

The mismatch between revenue raising capacities and the spending responsibilities of the Commonwealth and State governments in Australia results from the provisions of the Australian Constitution, the High Court's interpretation of those provisions and conventions established since federation, and States receding taxation powers. These factors have tended to constrict the revenue raising capacities of the States, while leaving them with responsibility for providing the main services, including hospitals, schools, roads and other transport facilities, police and justice services, which are used by Australians on a day-to-day basis.

Additional information about VFI in Australia is included in Appendix A.

Revenue

Australia's tax system is highly centralised. The broadest tax bases, personal and corporate incomes and goods and services, are dominated by the Commonwealth Government, with the States left to rely on comparatively narrowly-based and inefficient transactions taxes like stamp duties. The Australian Constitution provides that, where there is a conflict between a law of a state and a law of the Commonwealth on any matter, the Commonwealth law takes

precedence and the state law is invalid. The Commonwealth has used the precedence given to its laws to force States to vacate a number of fields of taxation.

It is recognised that over time some Commonwealth taxes have been abandoned by the Commonwealth and implemented by the States. This includes land taxes and pay roll taxes. However, these do not provide a broad and flexible tax base for the States.

Under the Intergovernmental Agreement (IGA) that accompanied the introduction of the GST, the States agreed to abolish certain taxes and not to reimpose them in exchange for the revenue from the GST. While the taxes abolished were relatively inefficient, the IGA constrains States' tax flexibility.

Spending Responsibilities

The Australian Constitution provides the Commonwealth Government with a limited number of exclusive powers and non-exclusive powers in a wide range of areas, such as trade and commerce; taxation; communications; defence; banking; insurance; foreign corporations, and some trading or financial corporations; and so on.

State governments retain responsibility for areas not mentioned in the Australian Constitution, like education, health, the environment and roads. However, the trend since federation generally has been for the Commonwealth Government to broaden its influence into these areas of traditional state responsibility through the use of specific purpose payments (SPPs).

Control over funding for specific purposes has given the national government policy input into these areas. In the past, SPP funding often came with matching funding conditions that further constrained States' budget flexibility, though the greater flexibility and focus on outcomes rather than inputs in the National Agreements that accompanied COAG's reform of SPPs agreed in November 2008 was directed at addressing this issue.

The Commonwealth, in consultation with the States, should consider opportunities to better balance revenue flows and spending responsibilities between the three levels of government as part of its further consideration of the recommendations of the Henry Tax Review.

Horizontal Fiscal Equalisation

Horizontal fiscal equalisation (HFE) is the principle that guides the distribution of GST revenue among the States. GST revenue payments account for the vast majority of federal general revenue payments to the States (\$41.2 billion in 2008-09).

Broadly, HFE seeks to equalise States' capacities to provide services to their residents. It seeks to do so by adjusting the payment of GST revenue to the States for the difficulties that States face in raising their own revenue or providing services to their populations. States' difficulties are those non-policy factors of demography, geography or economic environment that may reduce a State's ability to raise its own revenue or increase a state's costs of service delivery relative to other States.

Australia's definition of equalisation and its consequences

Over time the Commonwealth Grants Commission (CGC) has moved to the current position of attempting to make assessments across all areas of States' revenues and expenditures

and attempting to achieve full equalisation of capacity to provide services at the same standard.

In the 2010 Review of GST Revenue Sharing Relativities, the CGC revised the definition of HFE further to:

State governments should receive funding from the pool of goods and services tax revenue such that, after allowing for material factors affecting revenues and expenditures, each would have the fiscal capacity to provide services and the associated infrastructure at the same standard, if each made the same effort to raise revenue from its own sources and operated at the same level of efficiency.¹

In practice, this means that equalisation now extends to revenue capacities, expenditure needs and the capacity of States to have equal per capita stocks of infrastructure assets and net financial assets.

The CGC has extended equalisation beyond operating statement concepts of revenues and expenditures and into balance sheet concepts of physical assets and financial worth.

While most federations have some form of fiscal redistribution designed to assist the fiscally weaker States in providing services, other comparable federations do not attempt to equalise as fully or undertake as comprehensive a system of fiscal equalisation as Australia.

The consequences of this are: large cross-subsidies paid by the larger to the smaller States; a complex and data intensive method of equalisation yet one which still relies on large measures of judgement; and a method of equalisation which potentially has significant adverse impacts on resource allocation in Australia.

Since the GST was introduced, New South Wales and Victoria have largely carried the burden of cross subsidising the smaller States under HFE. Queensland and Western Australia have been more recent contributors, largely reflecting the trends in revenue raising capacities from the middle of the decade, particularly the rapid growth in revenue from mining royalties. These trends are evident whether the cross-subsidies are measured against a GST distribution based on state population shares or shares of GST revenue generated. Detailed information regarding this, with illustrative graphs is provided in Appendix A.

The HFE system is designed to flatten as much as possible the differences between the States. Above average revenues are equalised away and there is no incentive to improve efficiency. There is a disincentive against expanding the revenue base, either through increasing activity in the state or through undertaking additional expenditure to fund economic development, as the increased revenue capacity will result in lower GST revenue.

The efficiency costs of HFE take the following form:²

- fiscal transfers reduce incentives for resources (including people) to move from low productivity locations to high productivity locations
- States with higher grants may overspend on publicly provided goods and services relative to underlying community demands

¹ CGC, *Report on GST Revenue Sharing Relativities – 2020 Review*, Volume 1 – Main Report, p. 34.

² Garnaut and FitzGerald, Chapter 10.

- the current system provides modest incentives for States to increase their grants by increasing taxation or expenditure effort in areas where their difficulties are large
- there is little incentive in the current system for increasing the efficiency of public services due to the focus on cost difficulties in the expenditure assessments.

These efficiency costs are difficult to measure. An economic study commissioned by the 2002 Garnaut and FitzGerald review of Commonwealth-state funding arrangements put the quantifiable economic costs of the current system of interstate transfers at between \$150 million and \$280 million each year. However, Garnaut and FitzGerald's view was that the dynamic costs of the discouragement of policies favouring economic development and growth may be much larger.³

New South Wales has long argued for reform of the current system for distributing GST revenue payments between the States. The need to support States, such as South Australia, Tasmania and Northern Territory, with relatively low populations and/or economic bases is acknowledged. However, New South Wales considers that this can be done with a much simpler and more transparent method than currently, and one which potentially could have less adverse impact on efficient resource allocation in Australia.

An alternative system of fiscal equalisation could be based on:

- recognition of the need for fiscal support for South Australia, Tasmania and the Northern Territory to give those States the capacity to provide state services at a standard not appreciably below the average of the other States and Territories
- the measurement of their grant share should be based on the core economic and social functions that are shared by all States and Territories, eliminating the need to assess needs for functions that are largely the result of state policy choice
- once the shares for South Australia, Tasmania and the Northern Territory are determined, the remaining GST revenue could be shared between the other States and the ACT on an equal per capital basis.

The first step is a thorough investigation of the impact on national welfare of Australia's system of HFE.

The Commonwealth should commission, in consultation with the States, a thorough investigation of the impact on national welfare of Australia's system of Horizontal Fiscal Equalisation.

iii) Possible constitutional amendment, including the recognition of local government

The Australian Constitution does not refer to, or acknowledge the existence of the system of local government in Australia. In particular, section 51 of the Australian Constitution does not reserve to the Commonwealth the exclusive power to make laws with respect to local government in Australia.

³ Garnaut and FitzGerald, p. 2.

There are, however, provisions for local government in the constitution of Australian States. Any proposals to amend the Australian Constitution to recognise local government must take account of the existing arrangements in these State constitutions.

In New South Wales, the *Constitution Act 1902 (NSW)*, at section 51(1) States that there "shall continue to be a system of local government for the State [of New South Wales] under which duly elected or duly appointed local government bodies are constituted with responsibilities for acting for the better government of those parts of the State that are from time to time subject to that system of local government".

Therefore, local government in New South Wales exists due to the laws enacted by the State Parliament, principally being the *Constitution Act 1902 (NSW)* and the *Local Government Act 1993 (NSW)*, a succession of such latter statutes having been enacted for over a century. Local government bodies in New South Wales are statutory bodies of the New South Wales Government, for which NSW bears ultimate responsibility.

There are at least three forms of the Commonwealth constitutional recognition of local government possible. These are:

- *symbolic recognition* – a reference in the preamble to the Commonwealth Constitution recognising the existence of local government in the Commonwealth;
- *institutional recognition* – imposing a duty on States to retain a system of local government; and
- *financial recognition* – a recognition that local government requires a more secure revenue stream to provide the services and infrastructure expected by the community.

Two of these models have been put before the Australian electorate already. The 1974 referendum proposed financial recognition of local government, while the 1988 referendum sought institutional recognition.

While New South Wales currently does not support or express preference for any particular model, it notes that the 1988 referendum to provide a section 119A of the Australian Constitution would have required the States to provide for election of local government bodies. This provision represents a narrowing of the current power of New South Wales to provide for elected or appointed local government bodies.

Any proposal to amend the Australian Constitution to recognise local government should take account of, or allow for:

- existing provisions in State constitutions regarding local government arrangements within and between States;
- flexibility to restructure local government funding and reporting arrangements;
- existing statutory provisions of State Governments regarding shared functions, supervision and review of local government; and
- sustainability of funding for local government.

iv) Processes, including the Council of Australian Governments, and the referral of powers and procedures for enhancing cooperation between the various levels of Australian government.

The Council of Australian Governments (COAG)

The New South Wales Government is supportive of actions to strengthen institutions such as COAG to promote cooperative federalism. There is concern that the COAG agenda is becoming overloaded and may not be well understood by stakeholders. States are also experiencing considerable challenges in the negotiations undertaken for key aspects of COAG reform. There are no clear boundaries or principles under which the negotiations take place, and often the negotiations are less than ideal as they: i) do not allow for appropriate consultation; ii) do not recognise different service delivery models across Australia; and iii) on occasion have seen funding used as a lever to force agreement.

Further, due to COAG not having an institutional basis, it is open to the influences and variations of individual First Ministers around the table. To ensure COAG operates more efficiently, and rises above the ebb and flow of governments, an Intergovernmental Agreement to underpin its operations should be considered.

Such a mechanism should ensure that the COAG agenda is:

- High level - undertaking work in relation to priorities of national significance that require sustained, collaborative effort to progress and monitor; and
- Addressing key areas of shared Commonwealth and State/Territory responsibility and funding.

COAG as an institution should be strengthened by a mechanism such as an Intergovernmental Agreement that underpins its operations.

Referral of Powers

New South Wales is supportive of mechanisms to enhance cooperation between various levels of government. However, referral of powers is not necessarily the best option to achieve this, and in many cases there are better ways.

Other ways of achieving cooperation include harmonisation schemes and intergovernmental institutions. Any referral of powers needs to be considered on a case-by-case basis, with thorough review of alternative options which may be more efficient.

Any consideration of the referral of powers should be considered on a case-by-case basis with thorough review and evaluation of alternative options.

Powers of the States versus the Commonwealth

In considering the varied powers of States and the national government, several areas where there is risk of duplication and potential inconsistency are apparent with regard to criminal law.

It is acknowledged that crime crosses State, Territory and national borders, and that Australia therefore requires a comprehensive, co-ordinated and cohesive scheme to protect the community. However, unnecessary duplication, in areas such as serious drug offences and child sex offences, causes inconsistency in penalty structures, offence terminology, the role and treatment of victims of crime, court administration, and the provision of correctional services. It can also make the sentencing process unnecessarily complex.

In the civil law area, the Commonwealth and the States and Territories need to work cooperatively to ensure flexibility in dealing with matters that cross both jurisdictions. The referral of powers has been the primary mechanism for dealing with Commonwealth-State/Territory issues since the decision of the High Court in *Re: Wakim; Ex parte McNally* in 1999. While New South Wales believes that the referral of powers mechanism is generally sound, it should not be the only option for dealing with civil law matters that cross jurisdictions. The Commonwealth must also be willing to consider the removal of barriers imposed by the Australian Constitution as a means of ensuring the most consistent and cohesive application of the law.

The removal of barriers imposed by the Australian Constitution as a means of ensuring the most consistent and cohesive application of law should also be considered.

Intergovernmental Agreements (IGAs)

The reform agenda of COAG in recent years has involved the negotiation and drafting of numerous IGAs and related cooperative agreements such as National Partnerships. The IGAs are not only a key mechanism to drive reform, but also represent formal cooperation between the States and the Commonwealth Government. The New South Wales Government considers the approach taken to the development and drafting of these agreements, presents an opportunity for a cooperative remedy.

In recent years, the Commonwealth Government's approach to IGAs is not considered to have appropriate regard the fact that on both sides of the agreement, are sovereign Governments in their own right, and both are acting in the interests of the same people. One manner, in which this is evidenced, is by seeking agreements that are expressed to be legally binding. Agreements between a State and the Commonwealth should never be legally binding and rather should be dealt with appropriate Governmental channels.

A further manner in which this is evidenced are attempts to impose contractual obligations on States to comply with Commonwealth laws (for example privacy laws) which do not, and should not, apply to State Governments as they have their own laws. Finally, the development of intergovernmental agreements has also seen an increasing desire for reporting and accountability obligations on behalf of the Commonwealth that duplicate public accountability requirements that already apply to State Governments.

In the drafting and negotiation of IGAs, too much time is being spent on negotiating the terms of agreements that are not appropriate between sovereign Governments. Recognition of the States as sophisticated sovereign Governments in their own right is required. This would save time in the delivery of IGAs, and foster a far more collaborative approach between the States and the Commonwealth Government.

Intergovernmental Agreements (IGAs) should be negotiated and drafted in a manner which recognises States as sophisticated sovereign Governments in their own right to foster collaboration and deliver timely agreements.

v) *Strategies for strengthening Australia's regions and the delivery of services through regional development committees and regional grant programs.*

It is important to strengthen Australia's regions and protect their sustainability, particularly for remote regions. Changes in the demographic and industry profile across Australia will have major impacts on sustainability. The localised impact of demographic shifts may vary, and in some cases, may be substantially greater in certain local communities. Some towns and regional centres may experience dwindling populations, while others may experience significant growth due to migration.

This requires all three levels of government working together to meet the individual needs of those communities. Strategies must be developed which are region or state specific, as no two States or regions are alike. Future governance, funding, and service delivery in regions should:

- Better reflect the needs of local communities, for example to support more innovative and cost-effective service delivery for local communities through greater pooling of resources;
- Enable more effective partnering, including with State and Commonwealth Government and private entities; and
- Provide increased capacity to meet challenges posed by demographic change, environmental and local economic impacts.

A key reform that New South Wales has undertaken is to improve local councils' management of community assets. The New South Wales Government is advancing the implementation of a major reform whereby councils undertake a long term, integrated approach to planning, operations and reporting. Key elements of the reform include the requirement for councils to develop a resourcing strategy and changes to the way councils report on their performance. In summary, the new system will open the way for councils and their communities to have important discussions about funding priorities, service levels and preserving local identity and to plan in partnership for a more sustainable future.

Better service outcomes may also be achieved by encouraging councils to enter into strategic alliances or other forms of collaborative arrangements. Such collaborative arrangements may be able to improve financial savings, service standards and completion of projects that would not otherwise have been achievable.

Strategies to strengthen Australia's regions should foster collaborative arrangements and encourage long term approaches to planning and service delivery.
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