

SUBMISSION NO. 9 
Inquiry into National Funding Agreements

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The Secretary
Joint Committee of Public Accounts and Audit
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Canberra ACT 2600

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Dear Sir/Madam

SUBMISSION TO THE INQUIRY INTO NATIONAL FUNDING AGREEMENTS

The Business Council of Australia (BCA) is pleased to provide a submission to the Joint Committee of Public Accounts and Audit's Inquiry into National Funding Agreements.

The area of national funding agreements and the broader matter of federal financial relations will be of growing importance for Australia in the years ahead and a policy area in which the BCA will have a strong interest.

The BCA supports the revised federal financial framework as reformed in 2008, which aims to give states greater flexibility in key policy areas, along with higher levels of accountability through annual benchmark reporting. The reforms of 2008 rationalised 92 Specific Purpose Payments into six national agreements. However, since this time we note that 51 new national partnership agreements have been agreed by COAG with this number to increase substantially as more agreements under development are finalised.

The increase in the number of national partnership agreements highlights the need for the Council of Australian Governments (COAG) to be more disciplined in delivering on the intent of the framework. In particular, the BCA:

- Does not want to see the continuing proliferation of new national partnership agreements as in many cases these agreements are effectively reintroducing a specific purpose payment approach.
- Would prefer that the states retain their flexibility over how they deliver services without there being undue and excessive Commonwealth direction.
- Supports efforts to keep the COAG agenda and associated funding agreements tightly focused on efforts to lift the productive capacity of the economy.

At the same time, it will be necessary to address a number of anomalies in the present Commonwealth–state fiscal arrangements that impose disincentives for states to pursue sensible reforms. The recent announcement by the Treasurer of a

review of the distribution of GST revenues and the forthcoming tax forum will provide an important opportunity to address these related issues.

The BCA believes that having an effective Commonwealth–state architecture is essential if Australia is to successfully address a range of looming policy challenges in areas such as health, education and infrastructure. The architecture should respect the roles and responsibilities of each tier of government and deliver effective and accountable government. It should seek to capture the benefits of competitive federalism while also delivering effective collaboration and cooperation on issues of national significance.

Vertical fiscal imbalance is a longstanding characteristic of our system of federal–state relations and the architecture must necessarily accommodate this. State governments are responsible for fulfilling significant service delivery responsibilities, yet are increasingly reliant on transfers from the Commonwealth as the dominant collector of tax revenues.

The BCA notes that in the 10 years to 2008–09, the states' expenditure responsibilities grew at over twice the rate than their own tax revenues grew. In 2008–09, this left the states collecting around 15 per cent of aggregate tax revenue, while being responsible for about 42 per cent of aggregate government expenditures in Australia. While the Commonwealth Government collected almost 85 per cent of all tax revenue, it then redistributed a third of this to the states through the redistribution of GST revenues and via national funding agreements under the auspices of COAG. Commonwealth Treasury estimates suggest that national funding agreements for 2010–11 will represent over 13 per cent of total Commonwealth expenditure.

The BCA further notes that the Treasurer has recently announced a review of GST distribution to be completed towards the end of 2012. We also understand that there will be a discussion of state taxes at the tax forum in October this year. These processes have the potential to make an important contribution to enhancing the efficiency and effectiveness of federal financial relations. However, each of these processes must be cognisant of the complex interaction between state taxes, the distribution of GST revenues and COAG national funding agreements.

An adjustment in any one of these areas can potentially have an impact on incentives for efficient service delivery and reform in other areas.

For example, in undertaking the fiscal equalisation process to distribute GST revenues to states, the Commonwealth Grants Commission takes into account the fiscal capacities of states, which includes their capacity to raise revenue from various tax bases as well as funding transfers from the Commonwealth for specific purposes. The following two examples illustrate the perverse outcomes that can emerge from interactions between various parts of the federal financial framework:

- Reward payments received under COAG funding agreements for timely implementation of reforms over and above those received by other states can 'raise a state's fiscal capacity' and result in a subsequent reduction in its GST distribution.
- Some states have also highlighted that undertaking worthwhile reforms independently of other states (e.g., reducing inefficient state taxes) can reduce a

state's share of GST revenue under the equalisation process. This is because the state is effectively recognised as not fully exploiting the revenue raising potential of its own tax base.

The review of GST distribution will doubtless address such issues in detail. It remains the case, however, that reform in the three areas must be effectively integrated and sequenced to ensure that a combination of reforms does not have the unintended consequence of reinforcing or introducing potential disincentives to effective performance delivery or the pursuit of beneficial reform.

One of the risks of vertical fiscal imbalance in the federal–state architecture is that the accountability between the raising of revenue and the responsibility for funding programs can become blurred. For example, the Commonwealth could avoid accountability for expenditure of funds because it is the states that have actual responsibility for disbursing the expenditure. Similarly, states could argue that they are not able to deliver services adequately due to a lack of funding from the Commonwealth.

As Richard Bird and Michael Smart submitted to the Henry review, if state governments are to act responsibly and in the interests of their residents they should face a so-called 'hard budget constraint'.¹ This means that they are able to increase or decrease spending only by increasing or decreasing their revenues in such a way that they are publicly responsible for the consequences of their actions.

Given this context, it is imperative that the framework for intergovernmental transfers, including national funding agreements, provides incentives for governments to fulfil their obligations effectively, by making performance outcomes transparent and driving public accountability for those outcomes.

The BCA supported COAG's reforms to the Intergovernmental Agreement on Federal Financial Relations in 2008, which saw a rationalisation of 92 Specific Purpose Payments down to six national agreements. We consider that giving the states greater flexibility in key policy areas, along with higher levels of accountability through annual benchmark reporting, is a sound framework *if implemented effectively*.

Unfortunately, in the period since the Intergovernmental Agreement was agreed, there has been a proliferation of national partnership agreements which has, in some areas, effectively reinstated Commonwealth direction over funding. In some instances additional processes and governance layers have been imposed that have reduced the transparency and accountability gains of the initial reforms, while placing considerable administrative burden on governments.

The Productivity Commission's recent attempt to catalogue COAG reforms is illustrative of the unwieldy governance burden of the COAG agenda that has accumulated. According to the commission, the reforms currently before COAG "... comprise around 325 documents made up of the six national agreements, 51 national partnerships, 230 implementation plans and 27 intergovernmental

¹ Prof R. Bird and M. Smart, 'Assigning State Taxes in a Federal Country: The Case of Australia', paper presented at the Tax and Transfer Policy Conference, 18–19 June 2009.

agreements and other initiatives.”² These figures do not include numerous national partnerships and implementation plans still under development.

In order to deliver on the outcomes of the national funding agreements, the BCA believes that COAG must have a focused set of priorities and an operating model that is geared to the timely and coordinated implementation of often difficult reforms in the national interest. In this regard we supported COAG’s agreement in February this year to streamline COAG’s priorities and operations around five strategic themes, as well as rationalising ministerial councils.

Bearing this in mind, the BCA suggests that the committee’s inquiry should seek to determine the extent to which the current national funding agreement framework is consistent with the recently streamlined and reprioritised agenda of COAG and whether it is conducive to timely and effective reform.

As part of the Intergovernmental Agreement, the COAG Reform Council has a pivotal role to play in providing greater transparency of COAG’s progress in delivering reforms and thereby increasing accountability of governments for reform outcomes. The BCA believes that the council has substantially lifted the level of transparency and made some progress in raising the broader public understanding of the progress of COAG reforms. However, in order to perform its role effectively, the council is highly dependent on the timely provision of quality data and information from all governments and on effective direction from COAG in continuing to improve its performance reporting framework.

In this regard, the COAG Reform Council has made a number of recommendations in relation to addressing risks to reform as well as improving the performance reporting framework and data collection. If the council is to improve the standard of its reporting in order to promote greater accountability and transparency over time then COAG must address these recommendations in a timely fashion. Based on publicly available information, the BCA notes that COAG has only responded to the recommendations from three of the council’s 14 reports released since 2009.

The terms of reference for the committee’s inquiry suggest that parliamentary scrutiny of national funding agreements may be warranted. The BCA does not concur with this view. Rather than having a specific role for parliamentary scrutiny of national funding agreements, there is substantial opportunity to increase transparency and public scrutiny of the deliberations of COAG and its supporting governance structure, including as it relates to funding agreements.

An example of the need for greater transparency of COAG’s deliberations that is relevant to the committee’s inquiry is the existing review of the effectiveness of funding agreements that COAG requested Heads of Treasuries to undertake by the end of 2010. It is not clear at this stage whether this report has been completed or considered by COAG. There is a strong argument for making such a report public given the current deliberations of your inquiry and on the basis that these funding agreements account for such a significant proportion of Commonwealth expenditure.

² Productivity Commission, ‘Catalogue of COAG Reforms and Initiatives’, Annex to *Impacts and Benefits of COAG Reforms: Reporting Framework*, Research Report, Canberra, December 2010, pp. 2–3.

The BCA looks forward to the contribution that the committee's report will make in this important aspect of federal–state relations.

Yours sincerely

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