

SUBMISSION NO. 8 AN
Inquiry into National Funding Agreements

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- 3 MAY 2011

Mr R Oakeshott MP
Chair
Joint Committee of Public Accounts and Audit
PO Box 6021
Parliament House
Canberra ACT 2600

Dear Mr Oakeshott

I refer to the Inquiry into National Funding Agreements being undertaken by the Joint Committee on Public Accounts and Audit.

A submission from the Tasmanian Government responding to the Inquiry Terms of Reference is enclosed.

Thank you for the opportunity to contribute to the Inquiry and I look forward to seeing the Joint Committee's report when completed.

Yours sincerely

Lara Giddings MP
Premier



Submission by the Tasmanian Government

Joint Committee of Public Accounts and Audit

Inquiry into National Funding Agreements

April 2011



Tasmania
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Inquiry into National Funding Agreements

The purpose of this submission is to provide the Tasmanian Government's comments in relation to the Inquiry into National Funding Agreements (Inquiry) by the Joint Committee of Public Accounts and Audit (Committee).

Executive Summary

- The significant imbalance between the respective revenue raising powers and expenditure responsibilities of the Commonwealth and state and territory (the state) governments, results in Commonwealth funding comprising a large proportion of state budgets.
- The Tasmanian Government firmly supports the current framework for the provision of Commonwealth funding, via general purpose and specific purpose payments, under the *Inter-governmental Agreement on Federal Financial Relations (IGA)*.
- The distribution of Commonwealth general purpose funding (in the form of the GST) according to the principle of horizontal fiscal equalisation (HFE) is strongly supported. Without HFE, there would be much greater disparities in the quality of life of Australians living in different states.
- The recent reform of Commonwealth specific purpose funding, under the IGA, has represented an important shift in federal financial relations. Rather than both parties focusing on micro-managing projects (which diverts resources away from service delivery) the reform focuses on the public transparency of government performance through clearly specified output and outcome expectations and measurement.
- A recent Heads of Treasuries (HoTs) Review of specific purpose funding agreements under the IGA provided recommendations focused on ensuring the IGA reforms were upheld in practice and addressing the implementation challenges/shortfalls. The agreed aim of this Review was to ensure the principles encapsulated in the IGA remain sustainable and mutually beneficial to both levels of government and, importantly, ensure efficiency in the administration and expenditure of taxpayer funds whilst maintaining a focus on government performance accountability to the public.
- The implementation of the HoTs Review recommendations is critical to ensuring that the intent and full benefits of the IGA are realised. Senior Officials from First Ministers' and Treasurers' agencies are working to implement the HoTs Review recommendations, as agreed by the Council of Australian Governments.

1. Introduction

Revenue transfers from the Commonwealth are a vital source of revenue for the states. These transfers are required to address the significant imbalance between the respective revenue raising powers and expenditure responsibilities of the Commonwealth and state governments.

The Commonwealth collects around 72 per cent of total national General Government revenue, but is only directly responsible for around 55 per cent of total General Government expenditure. This creates vertical fiscal imbalance (VFI) between the Commonwealth and the states.

Commonwealth-state financial relations reform has experienced significant change since the mid 1990s. Four major milestones have been:

- the maintenance of real per capita general purpose funding;
- the Commonwealth acting to maintain state taxation revenues in light of High Court challenges;
- the introduction of the Goods and Services Tax (GST), and associated abolition of a number of state taxes, providing the states with access to a robust and growing tax base; and
- the reform of specific purpose funding, with an emphasis on increased efficiency and public accountability.

In 2010-11, revenue transfers from the Commonwealth to Tasmania are likely to total \$3.1 billion, constituting close to two-thirds of the State's total annual General Government revenue.

The Tasmanian Government therefore welcomes the opportunity to contribute to the current Inquiry. This submission directly responds to each element of the Inquiry's Terms of Reference.

2. Response to Terms of Reference

2.1 *"the changing dynamics of grants to states and territories, the types of grants that are made and the principles, agreements and legislation governing these grants."*

The revenue capacity of a government should be sufficient for it to discharge the expenditure responsibilities for which it is accountable to its citizens. This suggests the case for a re-assignment of the taxation power in Australia, given that this country has one of the highest levels of VFI amongst federations. However, in the absence of such a re-assignment, financial transfers between levels of government are necessary and should be made in a way that minimises transaction costs (which are ultimately borne by taxpayers).

The transfer of revenue from the Commonwealth to the states is an essential part of the financial relations between different levels of Australian government. These transfers are fundamentally linked to the nature of the Australian Federation and the way in which it has developed. In particular, Commonwealth-state financial relations both derive from and reflect the differing powers and responsibilities of each level of government.

The need for such revenue transfers and principles governing their distribution is outlined in further detail in Appendix 1 - Vertical Fiscal Imbalance (VFI) and Appendix 2 - Horizontal Fiscal Equalisation (HFE).

Types of Commonwealth Transfers and their Size

Commonwealth revenue transfers continue to be a large proportion of state budgets as a result of VFI.

Commonwealth revenue transfers to the states take two main forms - general purpose payments (GPPs) and specific purpose payments (SPPs). These payment types are discussed in more detail below.

General Purpose Payments

GPPs are untied payments, sourced from net GST revenue, which can be used at a state's discretion. In 2010-11, Tasmania's share of GST revenue is estimated to be \$1.7 billion, which equates to around 55 per cent of Commonwealth revenue transfers to the State.

The methods used to set the total amount of GPPs have varied significantly since the mid-1970s. Currently, the Commonwealth distributes to the states all the revenue it receives from the net GST. This revenue replaced the previous financial assistance grants and the revenue from many state taxes abolished when the GST was introduced in 2000.

Like all states, Tasmania's share of GST revenue is based on its share of the national population, adjusted by a weighting factor known as the GST relativity, which reflects the State's assessed need for financial assistance. The relativities for each state are determined by the Commonwealth Grants Commission (CGC) in accordance with the principle of HFE (refer to Appendix 2).

The CGC's assessment methods for determining the GST relativity are reviewed around every five years, in consultation with the states. In 2010, a five year work-program was completed, which significantly overhauled the CGC's assessment methods with an emphasis on simplification. This regular review process ensures that the CGC methods are robust, contemporary and achieve HFE.

More recently, the Commonwealth has commissioned a review of the distribution of the GST revenue. The review is to be conducted by former New South Wales Premier, Nick Greiner; former Victorian Premier, John Brumby; and South Australian businessman, Bruce Carter. An interim report is to be delivered in February 2012, with a final report in September 2012.

The Tasmanian Government strongly supports the existing principle and practice of HFE on the basis that it is fair and equitable for all states. HFE seeks to ensure that states have the capacity to provide the national average level of service, despite their structural and inherent differences. Any move towards an equal per capita distribution of GST revenue would have a disproportionately larger impact on smaller states and result in greater regional disparities,

Specific Purpose Payments

SPPs are conditional or tied funding, in the form of national SPPs and National Partnership (NP) payments:

- National SPPs are allocated to the broad service sectors for which they relate (including healthcare; schools; skills and workforce development; affordable housing; and disability services);
- NP payments are used for purposes as agreed with the Commonwealth. NP payments are used to fund specific projects, facilitate actions by the states on nationally significant reforms and reward those jurisdictions that deliver on reforms.

In 2010-11, SPPs to Tasmania are expected to total \$1.4 billion, which represents around 45 per cent of Commonwealth revenue transfers to the State.

SPPs have been subject to significant rationalisation and reform, through the introduction of the new IGA, agreed by the Council of Australian Governments (COAG) in November 2008. Prior to the new IGA, states received more than 90 different SPPs, many at small funding levels. This resulted in inefficient and high administrative costs (through compliance and reporting arrangements) and a lack of transparency and public accountability.

The National Health and Hospitals Reforms will have a material impact on the National Healthcare SPP. It will effectively become increasingly tied in nature, because payments will be made according to hospital activity.

Mix of GPPs and SPPs

The following table details the size of each type of Commonwealth revenue transfer to the states (collectively) since 1980-81. There has been a shift in the mix of untied to tied funding over that period. The past two years has seen a large increase in SPPs and NP payments to the states under the IGA. At an aggregated states level, SPPs currently represent around 54 per cent of Commonwealth revenue transfers. For individual states, the percentage of GPPs relative to SPPs will vary.

Table I – Commonwealth Transfers to the States

	1980-81	1990-91	2000-01	2006-07	2007-08	2008-09	2009-10
General revenue transfers (\$m)	7 090.2	13 931.6	27 634.5	39 551.9	42 453.5	42 351.3	44 693.0
% share	55.7	48.8	59.0	58.1	57.0	50.4	45.9
Specific purpose payments (\$m)	5 682.5	14 637.9	19 206.9	28 549.0	32 035.8	41 655.1	52 519.5
% share	45.7	51.2	41.0	41.9	43.0	49.6	54.1
Total	12 722.8	28 569.5	46 841.4	68 100.9	74 489.4	84 006.3	97 212.5

Source: 2010-11 Commonwealth Budget – Budget Paper No. 3.

CGC Process and the Treatment of SPPs and NPs

The receipt of SPPs (ie tied funding) affects the amount of GPPs (ie untied funding) a state receives. That is, when the Commonwealth funds states for particular projects or assists with the provision of state-type services, these SPPs are taken into account by the CGC in assessing the relative financial needs and GST requirements of each state.

This means that there are generally no “winners” or “losers” when the Commonwealth announces funding for specific purposes for particular states.

Where a state, or number of states, receive Commonwealth SPPs (such as the Building Australia Fund), it simply means that the Commonwealth is meeting an increased share of those states' financial needs through tied funding payments, which will therefore reduce the amount of GST revenue they require, as assessed by the CGC.

The converse of this analysis is that states can forgo tied SPP funding, through NP payments, and receive more untied GPPs (ie GST revenue), over time, via the CGC process.

As part of the current debate associated with the review of the distribution of GST revenue announced by the Commonwealth Government, some observers have claimed that the CGC equalisation process reduces incentives for states to undertake economic reforms and improve service delivery efficiency. In fact, all state and territory governments have incentives to reduce costs as they will receive the benefit of greater budget flexibility and are not discouraged from improving efficiency by the equalisation process.

There is a range of incentives for state governments to improve their economic wealth, the most significant being the desire to improve the wealth of their communities. State governments are incentivised to maximise efficiency through public accountability to their electorates under our democratic system. The national performance reporting framework under the IGA supports this accountability regime. However, the full implementation of the reforms to the IGA recommended in the Heads of Treasuries (HoTs) Review Report referred to later in this submission is essential if this element of the accountability incentives is to be effective.

The Current Australian Framework for Federal Financial Relations

Based on the terms of reference for the Inquiry, it is assumed that the Committee is primarily concerned with Commonwealth SPPs, particularly in relation to public accountability. The remainder of this submission is therefore focused on SPPs, rather than GPPs.

The introduction of the IGA in 2009 and its subsequent amendment have significantly reformed specific purpose funding. The objective of the IGA is to improve the wellbeing of Australians through:

- collaborative working arrangements, including clearly defined roles and responsibilities;
- enhanced public accountability with a focus on outcomes;
- reduced administrative and compliance costs; and
- stronger incentives to implement reform.

The focus of the new IGA is on removing prescription imposed by the Commonwealth on service delivery by the states, while moving to clearer roles and responsibilities and outcome-based public accountability.

The IGA establishes three broad types of SPPs and agreements:

- *National Agreements (NA)*: which are policy agreements (as opposed to funding agreements) relating to agreed objectives, outcomes, outputs and performance benchmarks in broad service sectors. There are six NAs in the areas of healthcare; education; skills and workforce development; disability; affordable housing; and Indigenous reform.
- *National SPPs*: which are payments that may be associated with an NA, but are not contingent on any conditions in that NA. National SPPs are allocated to the key service delivery sectors and are based on states' relative population shares. National SPPs provide on-going base level funding to support NAs.
- *National Partnerships (NP)*: that can be either reform or project-based and may provide for payments to the states. NPs are for agreed joint purposes and have a limited timeframe, usually no more than five years. NP payments tend to be structured to encourage the achievement of milestones or performance benchmarks.

NP payments are made from the Commonwealth to the states under Part 4 of the *Federal Financial Relations Act 2009* and are subject to the provisions of the *Financial Management and Accountability Act 1997*.

Under the IGA, the performance of each jurisdiction in delivering outputs or achieving outcomes under NAs and NPs is independently monitored and assessed by the COAG Reform Council (CRC).

The commencement of the new IGA represented an important evolution in federal financial relations. Rather than focusing on micro-managing projects, which can divert resources away from service delivery, the IGA focuses on the public transparency of government performance through clearly specified output and outcome expectations and measurement.

Previously, federal financial relations were characterised by arrangements whereby the Commonwealth placed a high degree of prescription on a large number of payments to the states, which constrained flexibility and innovative service delivery, making it difficult for states to set their own priorities and address their specific circumstances to achieve the best overall community outcomes. It also created inefficiencies, with the Commonwealth devoting unnecessary time to administering many payments and agreements¹.

2.2 "the extent to which the current systems for funding agreements satisfy the requirements of all levels of government, and any suggestions for changes to the process."

The introduction of the new IGA represented a major step forward in Commonwealth-state financial relations.

National SPPs no longer present significant budget concerns for states, as the conditionality previously associated with these payments has been alleviated. This allows states greater budget flexibility, policy and service delivery flexibility to tailor spending in the key sectors to produce the best local results.

Additionally, the IGA is intended to improve the quality and effectiveness of government service delivery by removing Commonwealth control over state service delivery and focusing on the outcomes.

Experience over the past two years has demonstrated that the IGA promise of a simplified and more transparent system of Commonwealth payments has not been fully realised. In practice, adherence to the core IGA principles that focus only on outcomes and outputs has been inconsistent and poor in a number of instances.

Rather than being concerned mainly with outcomes, many funding agreements remain focused on inputs (where and how funds are spent) with limited regard for what is actually being achieved. In some cases, the agreements remain highly prescriptive and continue the practice of Commonwealth micro-management of state service delivery. This reflects the on-going challenge in achieving a full shift towards an outcome-focused model for federal financial relations.

A major source of inconsistency with IGA principles arises from the way in which Implementation Plans (IPs) to NPs are developed. Under the IGA, IPs are intended as a means of dealing with state-specific characteristics associated with implementation.

¹ "Federalism and the Engine Room of Prosperity", speech by Commonwealth Treasurer, Australia and New Zealand School of Government annual conference, Melbourne, 11 September 2008.

In practice, IPs are developed for most NPs and the design of IPs is often in conflict with IGA principles because of the use of input or financial controls, prescription around how programs are delivered and onerous reporting requirements.

By way of example, IPs developed under the Water for the Future NP - and specifically the Supporting More Efficient Irrigation in Tasmania IP - contain both input and financial controls, and do not have an outcomes-focus. This IP is evidence of the Commonwealth continuing to directly manage programs delivered by the states, and is representative of the on-going challenge in achieving a full shift towards an outcome-focused model for federal financial relations.

The proliferation in the number of funding agreements is also a concern. Under the IGA, new agreements were to be limited in number and restricted to major projects and reforms of national significance. This was an important objective related to streamlining payment arrangements and minimising the diversion of resources into unnecessary administrative effort.

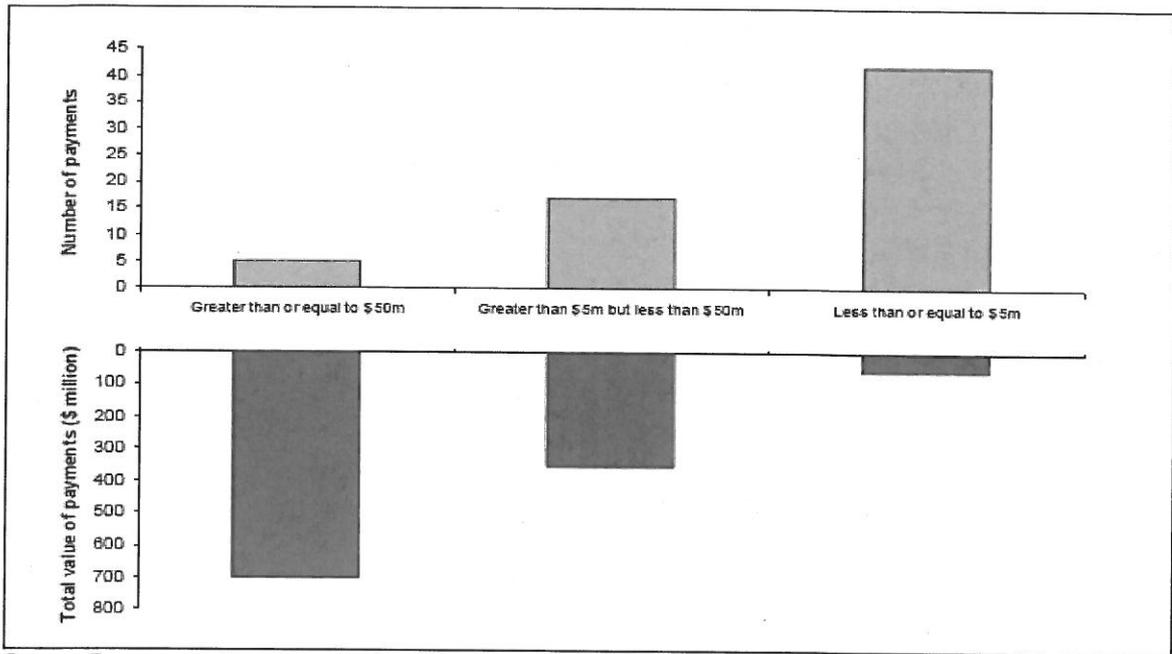
However, NPs are being used to provide Commonwealth funding for ongoing state activities. Under the IGA reforms, these payments should be provided through SPPs or through General Revenue Assistance. The risks for states with funding for ongoing activities being made via NPs is the uncertainty over funding beyond the life of the NP. In the absence of a renewed commitment from the Commonwealth, the states are exposed to picking up the expenditure responsibility without the revenue support, particularly where it would prove very difficult to withdraw the new or increased service level that has been funded by the NP. The reformed SPP arrangements were put in place under the IGA, to provide certainty to states in areas of ongoing service responsibility.

There has also been a tendency to create new funding agreements to support NP payments for relatively small activities or projects. For example, the Indigenous Clearing House NP involves a \$16 000 per annum Tasmanian contribution.

A proliferation of funding agreements leads to increased administrative costs and a growing reporting burden for the states. This is a more acute issue for smaller jurisdictions, such as Tasmania.

By way of example, Tasmania is expected to receive around 64 payments from the Commonwealth in 2010-11. The vast majority of these payments are provided under individual agreements. The following chart shows that Tasmania is expected to receive a disproportionately large number of small value payments. There are 42 payments with an annual value of less than or equal to \$5.0 million, including one payment of just \$5 000.

Chart 1 – Number and Annual Value of Commonwealth Payments to Tasmania, 2010-11



Source: Commonwealth payment estimates are based on those used in Tasmanian Budget Paper No 1 The Budget 2010-11 (Chapter 9).

In addition, there have been a number of NPs developed that would be better managed as Commonwealth Own Purpose Expenditure. An example is the Digital Regions Initiative NP which provides competitive project funding under a Commonwealth program.

Given this experience, COAG tasked HoTs to review NAs and NPs (including their related IPs) and report by 31 December 2010. The HoTs Review reaffirms the commitment of all governments to the underlying reform principles of the IGA, but recognises that there is significant room for improvement in a number of areas of implementation. The HoTs Review considers the implementation of the IGA principles should be strengthened, where necessary, to sharpen the focus on outcomes, to improve responsiveness and to enhance public accountability.

The HoTs Review provides a number of recommendations aimed at addressing the remaining implementation challenges to ensure the sustainability of the IGA. This includes the redesign of agreements that are inconsistent with the IGA principles, improvements to performance monitoring and reporting, processes for dealing with proliferation in the number of funding agreements and clarification around roles and responsibilities.

The Tasmanian Government supports the HoTs Review recommendations, which if implemented will promote the sustainability of the IGA and notes that work is currently being progressed through Senior Officials in First Ministers' and Treasury agencies to implement the recommendations.

It is critical that the HoTs Review recommendations are implemented to ensure that the full benefits of the IGA are realised.

2.3 “the need to balance the flexibility to allow states and territories to determine their own priorities with the mechanisms for monitoring accountability and ensuring that the objectives of funding agreements are being achieved, noting the role of the COAG Reform Council.”

The IGA seeks to improve the quality, efficiency and effectiveness of government services by reducing Commonwealth prescription on state service delivery and increase states' flexibility to deliver services appropriate to their local circumstances.

This flexibility is balanced by increased accountability through:

- clearly specified roles and responsibilities for each level of government;
- a focus on the achievement of outcomes, efficient service delivery and timely reporting; and
- enhanced performance reporting through simpler, standardised and more transparent reporting.

The IGA is concerned with accountability to the public, not just for expenditure in delivering services, but more importantly for the quality and the efficiency of the services that are delivered by government and the outcomes achieved.

In addition, under the IGA the CRC has substantially expanded its role in independently assessing and publicly reporting jurisdictional performance. The public is now able to directly compare the performance of governments across key service areas, such as health, education and housing in delivering the outcomes agreed by COAG.

The implementation of the IGA has already contributed to increased public accountability of all governments through the development of a national performance reporting framework and easy access to all funding agreements that fall under the IGA, on the Ministerial Council for Federal Financial Relations website. Additionally, the CRC performance assessments are released publicly and published on the CRC website.

The CRC role complements the substantial public reporting of state and territory service delivery performance through the annual *Report on Government Services* (ROGS) and the reporting of progress against key Indigenous indicators through the biennial *Overcoming Indigenous Disadvantage* Report. Both of these reports are prepared by the Productivity Commission through the Steering Committee on the Review of Government Service Provision and have been produced for some time – in the case of the ROGS since 1993.

It should also be recognised that states are incentivised to achieve agreed outputs and outcomes under NPs, given that it is the states that bear the risk of any under-achievement.

The Tasmanian Government therefore considers that the IGA provides an appropriate framework that balances flexibility with accountability. However, it is the implementation of the framework and addressing issues identified in the HoTs Review that will ensure that this balance is achieved in practice.

2.4 *“the adequacy of parliamentary scrutiny of funding agreements, noting that such agreements are typically negotiated at executive-to-executive level.”*

Funding agreements under the IGA are transparent and publicly accessible. All funding agreements have clearly specified outcomes, outputs, performance indicators and defined roles and responsibilities. This allows for enhanced public accountability (and parliamentary scrutiny).

The Tasmanian Government does not consider parliamentary scrutiny to be lessened under the IGA, but rather enhanced with Parliaments and the public better able to judge the performance of governments and the achievement of outcomes for the community.

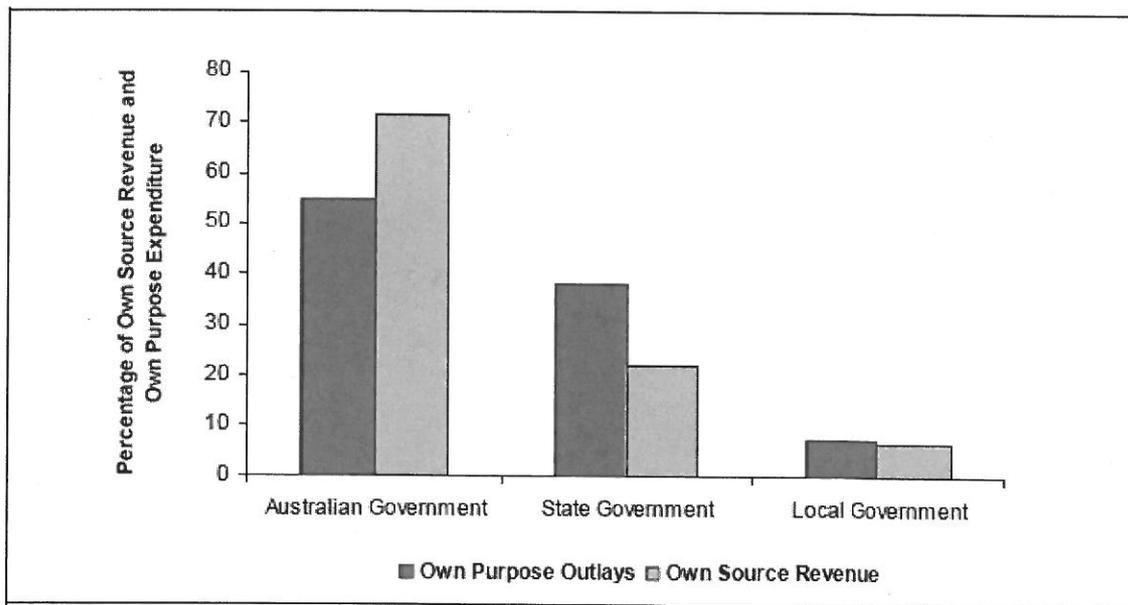
APPENDIX I VERTICAL FISCAL IMBALANCE

Since Federation, a financial relationship between the Commonwealth and the state governments has evolved in which the dominant characteristic is the fundamental imbalance between the revenue raising powers and functional responsibilities of each level of government.

The term vertical fiscal imbalance (VFI) refers to the difference between own source revenue and own purpose expenditure commitments for a level of government. This is illustrated in the following chart, which compares the percentage shares of revenue and expenditure on a consolidated basis for the Commonwealth, state and local governments.

The chart shows that, in 2009-10, the Commonwealth was predicted to raise around 72 per cent of total (General Government) revenue (including the GST pool as Commonwealth revenues), whereas its own purpose (General Government) spending was predicted to have only been around 55 per cent of total General Government outlays. In contrast, states' share of this revenue was predicted to have only been around 22 per cent, while combined state General Government outlays were predicted to represent around 39 per cent of the national total. Revenues and expenditures for local government were estimated to be much more closely aligned.

Chart A1 – Vertical Fiscal Imbalance



Source: *Government Financial Estimates 2009-10*, ABS cat no 5501.0.55.001.

Australia has a high level of VFI by world standards. As a result of VFI, there is a requirement for significant financial transfers from the Commonwealth to the states on an on-going basis.

Reforms to Commonwealth-state financial relations, which commenced under the original IGA in 2000 and continued under the new IGA agreed by COAG in November 2008, resulted in a substantial increase in VFI due to:

- the introduction and collection mechanisms associated with the GST;
- the associated agreement by the states to abolish a number of state taxes over time; and
- the states forgoing revenue replacement payments and Financial Assistance Grants.

APPENDIX 2 HORIZONTAL FISCAL EQUALISATION

In addition to VFI (refer to Appendix 1), another characteristic of financial relations in the Australian Federation is the degree to which fiscal capacities of the states differ.

In per capita terms, there are differences between the states in the cost of providing a range of common services and the financial resources available to fund them, including own source revenues and certain transfers from the Commonwealth (apart from general purpose payments). The causes of this horizontal fiscal imbalance are complex and varied (demographic, geographic and economic to name a few). Those causes over which a state has no policy control are the explicit focus of the horizontal fiscal equalisation (HFE) process associated with Commonwealth general purpose payments (ie the allocation of the net GST).

The HFE framework, which is administered by the Commonwealth Grants Commission (CGC) takes, as its starting point, the scope of state transactions and functions, including all related recurrent expenditures and revenues, which are considered the normal responsibility of state governments. The CGC's assessment attempts to measure the level of services each state could provide and the amount of revenue it could raise if it made the average Australian effort. The difference between assessed levels of service and revenue and the Australian average determines the shares of GST revenue.

The CGC process for determining each state's share of GST revenue is transparent, objective and policy-neutral. It does not compensate states for any economic or financial mismanagement, and states cannot directly affect their share of GST revenue.

In 2010-11, Tasmania will receive approximately \$676 million more in GST revenue than it would if the GST revenue were distributed on an equal per capita basis. Without HFE, Tasmania would be significantly disadvantaged, relative to the average fiscal circumstances of all states, because of its higher costs of providing services and lower capacity to raise revenue, both of which are unavoidable.