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COAG Reform Fund Bill 2008

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COAG Reform Fund Bill 2008

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Links: The relevant links to the Bill, Explanatory Memorandum and second reading speech can be accessed via BillsNet, which is at http://www.aph.gov.au/bills/. When Bills have been passed they can be found at ComLaw, which is at http://www.comlaw.gov.au/.

Purpose

To establish the COAG Reform Fund as a Special Account to provide financial assistance grants to the states and territories.

Background

Proposals for the reform of Commonwealth–state financial relations have been much debated. The COAG Reform Fund Bill 2008 (the Bill) is a measure in the government's proposed reform of Commonwealth–state financial relations.

Vertical fiscal imbalance

A feature of Australia's federal system is that power over spending and policy-making is being increasingly concentrated in the Commonwealth. This follows from the fact that the states have relatively large spending responsibilities but relatively few own-revenue sources whereas the Commonwealth has substantial power to raise revenue but relatively few Constitutionally-assigned spending responsibilities. The difference between the expenditure responsibilities of each tier of government and the own-source revenues available to that tier is called vertical fiscal imbalance. Australia is characterised by a relatively high degree of vertical fiscal imbalance compared with other federations. A consequence is that the states depend heavily on Commonwealth grants for revenue.[1]

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1. The evolution of the Commonwealth's financial domination of the states is described in Denis James, 'Federal-State Financial Relations: The Deakin Prophesy', *Research Paper*, no. 17, Parliamentary Library, Canberra, 1999-2000, at: http://www.aph.gov.au/library/pubs/rp/1999-2000/2000rp17.pdf. Accessed 3 November 2008.

Forms of assistance

The Commonwealth provides financial assistance to the states and territories in the forms of general revenue assistance—mainly GST revenue—and specific purpose payments (SPPs). The distribution of GST revenue is governed by the *Intergovernmental Agreement on the Reform of Commonwealth-State Financial Relations*. This provides, among other things, that:

- the states and territories can spend the GST revenue as they wish
- revenue from the GST is to be distributed among the states and territories based on horizontal fiscal equalisation principles, and
- the Commonwealth Grants Commission (CGC) is responsible for calculating the relativities used to determine the distributions.[2]

Horizontal fiscal equalisation

The CGC defines the principle of horizontal fiscal equalisation as:

> State governments should receive funding from the pool of Goods and Services Tax revenue and health care grants such that, if each made the same effort to raise revenue from its own sources and operated at the same level of efficiency, each would have the same capacity to provide services at the same standard.[3]

The principle thus seeks to ensure that each state has the financial capacity to provide services at national average levels and at average levels of efficiency. There is, however, no obligation on the states to provide the services they are funded for.

The CGC, when calculating the relativities, takes into account the fact that the states have different revenue–raising capacities and different spending 'needs'. For example, Western Australia has a strong capacity to raise mining revenue compared with the other states, while Queensland has a smaller need to spend on aged care than South Australia. These differences are reflected in the amount of GST each state receives. A state with a relatively high capacity to raise revenue, for example, has its GST entitlement reduced, while a state

2. For a fuller discussion, see Richard Webb, 'Developments in Commonwealth–state financial relations since 2000-01', *Research Brief*, no. 11, Parliamentary Library, Canberra, 2005-06.

3. Commonwealth Grants Commission, *Report on State Revenue Sharing Relativities 2008 Update*, 18 February 2008, p. 25 at: http://www.cgc.gov.au/__data/assets/file/0004/9850/U2008_FINAL_REPORT_REVISED_VERSION.pdf. Accessed 30 October 2008.

with a relatively large need for a particular category of expenditure has its share of the GST increased.[4]

The GST relativities the CGC calculated in its 2008 update resulted in NSW, Victoria, Queensland and WA in effect redistributing resources to Tasmania, the ACT and the NT.[5]

Specific purpose payments

The government's proposed reform of Commonwealth–state financial relations relates mainly to specific purpose payments (SPPs). They are payments the Commonwealth makes to the states and territories under section 96 of the Constitution. This section provides, in part:

> … the Parliament may grant financial assistance to any State on such terms and conditions as the Parliament thinks fit.

An example of an SPP is the grants to the states under the Australian Health Care Agreements to assist with the provision of public hospital services free of charge to eligible persons.

There has been considerable criticism of the use of SPPs. Some see SPPs as undermining the federal system of government by allowing Commonwealth involvement in areas beyond those stipulated in the Constitution. Other criticisms include the use by the Commonwealth of SPPs for short-term political purposes and to impose its priorities on the states.[6]

Problems associated with SPPs include a lack of accountability, duplication of administration and blame shifting. Where functions are shared between the Commonwealth and the states, another problem is cost-shifting whereby one tier of government attempts to shift costs onto the other tier. The states have also criticised the 'conditionality' attached to SPPs whereby the Commonwealth requires the states to meet certain undertakings as a condition of the states receiving grants. In particular, the states have criticised so-called 'input controls' such as the states having to match Commonwealth funding on a dollar-for-dollar basis.[7]

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4. For a discussion of horizontal fiscal equalisation, see Richard Webb, 'Horizontal Fiscal Equalisation', *Research Note*, no. 1, Parliamentary Library, Canberra, 2002-03 at: http://www.aph.gov.au/library/pubs/rn/2002-03/03rn01.pdf. Accessed 30 October 2008.

5. Commonwealth Grants Commission, op. cit.

6. For a discussion, see Scott Bennett and Richard Webb, 'Specific purpose payments and the Australian federal system', *Research Paper*, no. 17, Parliamentary Library, Canberra, 2007-08 at: http://www.aph.gov.au/library/pubs/rp/2007-08/08rp17.pdf. Accessed 30 October 2008.

7. ibid.

There have been numerous proposals for improving the operation of SPPs. They include:

- clarification of the roles and responsibilities of each tier of government so that duplication/overlapping of responsibility for service provision is reduced
- where responsibility for programs is shared between the Commonwealth and states, funds for related programs should be pooled rather than being earmarked to specific programs, and
- the broadbanding of programs.

An example of broadbanding is that which Garnaut and Fitzgerald proposed:

> The centrepiece of the proposed reform is a new cooperative model for SPPs in the key merit areas of health and aged care, and education and training. SPPs in these areas would be broad-banded into two national programs in which the States have clear authority over service delivery, without micromanagement and input controls. A third national program would be established in indigenous community development.[8]

As discussed below, the government is proposing a form of broadbanding similar to that proposed by Garnaut and Fitzgerald.

26 March 2008 COAG meeting

The Council of Australian Governments (COAG) is the peak inter-governmental body in Australia.[9] On 26 March 2008, COAG agreed a new framework for Commonwealth-state financial relations. The new framework will begin on 1 January 2009 (reform of healthcare funding will begin on 1 July 2009). A new intergovernmental agreement on Commonwealth-state financial arrangements is to be finalised by the end of 2008.

Objectives of the new framework include:

- reduced administrative and compliance costs and cost-shifting
- increased accountability for service delivery, and
- greater flexibility for the states to allocate resources to the areas they deem to be of greatest need and the means to deliver services.

Features of the new framework include:

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8. R. Garnaut and V. Fitzgerald, *Review of Commonwealth-State Funding. Final Report*, August 2002, p. 3.

9. COAG's membership comprises the Prime Minister, state Premiers, territory Chief Ministers, and the president of the Australian Local Government Association.

- a rationalisation of SPPs but without a reduction in total Commonwealth SPP funding for SPPs. The proposed rationalisation entails combining related SPPs (for example, those dealing with health) into fewer new national SPP agreements. Rationalisation will reduce the number of SPPs from more than 90 to five or six national agreements for the delivery of healthcare, affordable housing, early childhood development and schools, vocational education and training, and disability services. The national agreements will be ongoing but subject to periodic review
- the states will continue to receive—as general revenue assistance—payments where there are no compelling national objectives, for example, compensation for the revenue forgone following the commencement of the national scheme for the regulation of companies and securities
- less emphasis on conditionality. Rather, each national SPP will be supported by a mutually-agreed Statement of Objectives and Outcomes. Each Statement will specify
  - what the Commonwealth and the states expect to achieve from their joint involvement, that is, the objectives and expected outcomes[10]
  - the role of each jurisdiction, the responsibilities it will be accountable for, and the outputs it will deliver, and
  - indicators/measures of performance to assess whether or how well a jurisdiction has achieved outcomes.

National Partnership payments

Another feature of the framework is the new National Partnership payments. They fall into three categories:

- project payments: these will be made to support national objectives and to help fund the delivery of specific projects, for example, road and rail projects under AusLink
- facilitation payments: these payments may be used to help a state to lift its standards of service delivery in areas identified as national priorities, and
- reward payments: these will be an incentive to encourage the states to undertake reforms. The intent is that payments will be structured in such a way as to encourage the attainment of performance benchmarks.

Reward payments are similar to the previous National Competition Policy payments made to the states to encourage them to adopt competition reform.

10. The latter include enhanced social inclusion and addressing Indigenous disadvantage.

COAG Reform Council

The COAG Reform Council—an independent non-statutory body—will, among other things, report on performance information against SPPs outcomes, and assess whether predetermined performance benchmarks have been achieved under National Partnership agreements.

Funding

The government claims that the new framework will provide greater funding certainty for the states. The process for determining the level of funding has been described as follows:

> Importantly, the overall funding arrangements for the new national SPPs and the reform-based National Partnership payments will be negotiated as one financial package by Treasurers, through the Ministerial Council for Commonwealth-State Financial Relations, for endorsement by COAG. This will allow portfolio ministers to focus on the policy aspects of delivering more effective and efficient services. While the level of funding will have regard to the policy objectives, the new framework places policy — not funding — front and foremost … The initial overall funding package, including base funding and appropriate growth factors for the new national SPPs, and funding for the new incentive-based National Partnership reform payments, will be negotiated later in the year. Nevertheless, the Commonwealth has provided a clear commitment that no State will be worse off overall than they would be under the current arrangements and that National Partnership reform payments will be in addition to existing payments.[11]

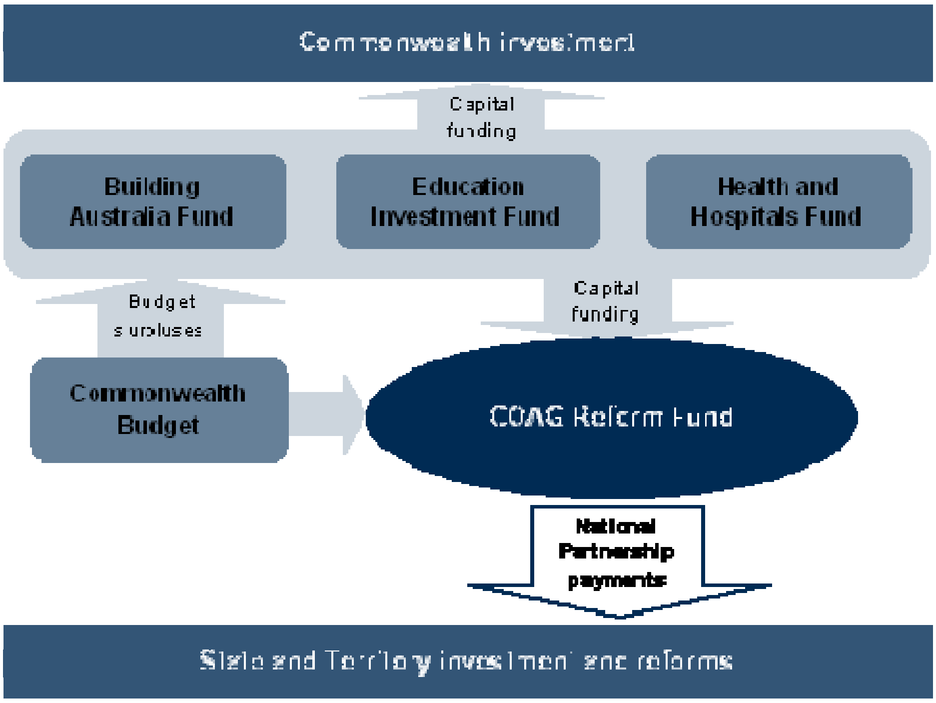
COAG Reform Fund

The COAG Reform Fund will be used to channel National Partnership payments and investment funds (see below) to the states. How this will work has been described as follows:

> A new COAG Reform Fund will receive contributions directly from the Commonwealth Budget as well as from three other funds being set up by the Government for capital investment — the Building Australia Fund; Education Investment Fund; and Health and Hospitals Fund. The purpose of these funds, which are to be financed largely from future budget surpluses, is to underpin future progress on investment and reforms in these key sectors. Where the investments are to be undertaken by the States, and the Commonwealth has agreed to fund these, the funding will be provided through the COAG Reform Fund in the form of National Partnership payments.
>
> To ensure that total capital spending from the funds is consistent with the Government's macroeconomic goals, the Australian Loan Council will provide advice on whether the combined spending envelope of both the Commonwealth and the

11. Budget Paper No. 3, 2008-09, p. 16.

> States can be delivered in prevailing economic conditions without putting at risk the Government's inflation target. The Australian Loan Council will not approve or advise on individual infrastructure projects.



Source: Budget Paper No. 3 2008-09, p. 18

Investment funds

The quote referred to three investment funds: the Building Australia Fund, the Education Investment Fund, and the Health and Hospitals Fund. (The Explanatory Memorandum and the Bill refer to these funds as 'nation-building' funds).

The Building Australia Fund

According to the government, the Building Australia Fund (BAF) will be established:

> … to help finance the current shortfall in critical economic infrastructure in transport and communications such as road, rail, ports and broadband, particularly where infrastructure requirements in these areas are not provided by the State and Territory governments or by the private sector.[12]

In terms of funding, the government proposed committing funds to the BAF from three sources: Budget surpluses from 2007-08 and 2008-09, the Communications Fund, and

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12. Budget Paper No. 1 2008-09, p. 7–5.

proceeds from Telstra 3. The government proposes to close the Communications Fund and transfer its assets to the BAF. The government also proposes to use the BAF to invest in a National Broadband Network. Spending on this will depend partly on the government's response to the Glasson Review.[13]

Education Investment Fund

In the 2008-09 Budget, the government announced that it would invest $11 billion in the Education Investment Fund (EIF) to finance skills, TAFE colleges and universities. The following is from the Budget Speech:

> Mr Speaker, the Education Investment Fund will finance capital investment in higher education and vocational education and training. It will receive an initial allocation of around $11 billion, including $6 billion from the Higher Education Endowment Fund.

When the government announced the formation of the EIF, the government proposed funding the remainder of $5 billion from the 2007-08 and 2008-09 Budget surpluses. The 2008-09 Budget transfers $304.0 million from the Higher Education Endowment Fund in 2008-09.

Health and Hospitals Fund

In the 2008-09 Budget, the government also announced that it will invest $10 billion in a new Health and Hospitals Fund (HHF) to finance improvements to hospitals and the health care system. The following is an extract from the 2008-09 Budget Speech:

> Mr Speaker, the Health and Hospitals Fund will finance health infrastructure. Key priorities include spending on hospitals, medical technology equipment, and medical research facilities and projects. The Fund will receive an initial allocation of $10 billion.

When the government announced the HHF, the intention was that the HHF would draw its initial $10 billion from surpluses in the 2008-09 and 2009-10 Budgets. The HHF will replace the Howard Government's $351.7 million Health and Medical Infrastructure Fund. The HHF is to be established by 1 January 2009. Full details are yet to emerge as to how projects will be assessed for funding, other than as part of each year's Budget process.

Special Accounts

The Bill proposes to establish the COAG Reform Fund as a Special Account. The Department of Finance and Deregulation defines a Special Account as an appropriation mechanism that sets aside amounts within the Consolidated Revenue Fund for expenditure

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13. The BAF is yet to be established by legislation.

for special purposes. In short, a Special Account is an accounting device into which funds relating to a specific activity are deposited and from which payments are made.

Australian Loan Council

As noted, establishing the COAG Reform Fund envisages a role for the Australian Loan Council in ensuring that total capital spending from the investment funds is consistent with the government's macroeconomic goals. The Australian Loan Council's function is to coordinate borrowing by the Commonwealth and state governments.[14] At the time of the May 2008-09 Budget, a major concern was inflation. But with the subsequent economic downturn, a greater concern is likely to be to support economic activity.

Basis of policy commitment

With respect to Commonwealth–state financial relations, the Labor Party's national platform for the 2007 election stated:

> 6. Many of Australia's biggest policy challenges involve the intersection of Commonwealth and State government responsibilities. In government, reforming the Federation will be an important priority for Labor. The cost shift and blame shift between governments costs Australian taxpayers billions of dollars each year. There is too much ambiguity about which level of government is responsible for a particular government program. This often creates difficulties for Australians who want to access the range of services shared by governments, in areas such as health care, aged care, childcare, disability services, and dental care. It is also often a significant problem for Australian businesses in dealing with conflicting and costly regulatory environments between Commonwealth, state and governments.
>
> 7. Accordingly, Labor will:
>
> - review areas of overlap and duplication of responsibility between the Commonwealth and State and Territory governments, with the aim of eliminating inefficiencies and clarifying responsibilities;
> - maintain a comprehensive system of horizontal fiscal equalisation based upon the per capita relativity recommendations of the Commonwealth Grants Commission;
> - maintain a system of general purpose funding to local governments which provides adequate funding for their needs;

14. For a discussion of the Loan Council's role, see Richard Webb, 'The Australian Loan Council', *Research Note*, no. 43, Parliamentary Library, 2001-02 at http://www.aph.gov.au/library/pubs/rn/2001-02/02rn43.pdf. Accessed 31 October 2008.

- continue to support specific purpose payments to States and Territories where these are appropriate to meet national objectives or ensure national standards, and ensure that those payments are used for the purpose for which they have been allocated; and

- ensure that State, Territory and local governments and their authorities are able to maintain and steadily improve their economic and social infrastructure.

8. Labor will also:

- seek to eliminate inappropriate duplication between Commonwealth, State and Territory, and local government functions and activities;
- support arrangements to voluntarily harmonise revenue bases and tax administration between the Commonwealth, States and Territories; and
- support arrangements to voluntarily integrate the administration of Commonwealth and State and Territory taxes and charges, where this has the potential to lead to economic benefits such as lower compliance costs for business.[15]

In the 2008-09 Budget Speech, the Treasurer, the Hon. Wayne Swan MP, announced:

> Where funds are used to finance capital projects with the States, they will be distributed to the States from the three new funds I have just announced through a new Council of Australian Governments (CoAG) Reform Fund.
>
> The COAG Reform Fund will also distribute funding provided in future budgets to the States for recurrent expenditure in areas of COAG national reforms, through new National Partnership payments.

Committee consideration

The Bill has been referred to the Senate Economics Committee for inquiry and report by 10 November 2008. At present, there are no details of the inquiry. The Nation-building Funds Bill (see below) will be referred to the Committee when introduced so an extension of time is possible.

Financial implications

There are no financial implications. The Bill does not appropriate any funds.

15. Australian Labor Party, *National Platform and Constitution 2007*, pp. 177–8, at http://www.alp.org.au/download/now/2007_national_platform.pdf Accessed 31 October 2008.

Main provisions

The Bill consists of three Parts. Part 1 contains preliminaries. Part 2 establishes the COAG Reform Fund and defines its purpose, while Part 3 deals with the terms and conditions of grants the Commonwealth makes to the states and territories.

Part 2—COAG Reform Fund

Clause 5 Establishment of the COAG Reform Fund

Subclause 5(1) establishes the COAG Reform Fund.

Subclause 5(2) specifies that the COAG Reform Fund is a Special Account. Note 2 to **subclause 5(2)** states that an amount originating in the so-called nation-building funds—the Building Australia Fund, the Education Investment Fund and the Health and Hospitals Fund—may be transferred to the COAG Reform Fund. Note 2 also refers to the *Nation-building Funds Act 2008* but the legislation for this has not yet been introduced into parliament.

Clause 6 states that the purpose of the COAG Reform Fund is to make financial assistance grants to the States and Territories.

Part 3—Terms and conditions of grants

Clause 7 deals with the terms and conditions of grants. **Subclause 7(1)** provides that it applies if an amount is to be debited from the COAG Reform Fund for the purpose of making a grant to a State or Territory **[paragraph 7(1) (a)]**, and if the grant is not covered by any of several provisions of the *Nation-building Funds Act 2008* [**paragraph 7(1) (b)**]. But absent the legislation for the *Nation-building Funds Act 2008*, the import of these provisions is unknown.

Subclause 7(2) deals with the proposed new intergovernmental agreement on Commonwealth-state financial arrangements, which is to be finalised by the end of 2008. **Subclause 7(2)** provides that the terms and conditions under which financial assistance is granted are to be set out in a written agreement between the Commonwealth and the State or Territory.

Subclause 7(3) provides that a Minister may enter into an agreement under **subclause 7 (2)** on behalf of the Commonwealth.

Clause 8 Delegation by a Minister is a clause found in other legislation whereby a Minister can delegate powers to other parties. **Subclause 8(1)** provides that a Minister may, by writing, delegate any or all of his or her powers under section 7 to the Secretary of a Department [**paragraph 8(1)(a)**] or to an SES employee, or acting SES employee, in a Department [**paragraph 8(1)(b)**]. **Subclause 8(2)** provides that in exercising powers under a delegation, the delegate must comply with any directions of the Minister concerned.

Concluding comments

The proposed framework for Commonwealth–state financial relations promises to go a long way in addressing many of the problems identified with existing SPP arrangements including the lack of accountability, duplication of administration, blame-shifting and cost-shifting. In particular, the proposed clarification of the roles and responsibilities of each tier of government should reduce many of these problems.

Implementing the framework, however, faces considerable challenges. One is to set performance benchmarks, outcomes, and performance indicators to assess whether objectives are being achieved. This is a formidable challenge because:

> … outcome/output measures of service delivery are difficult to define, measure and enforce in a robust way.[16]

Several aspects of the new framework are unknown. One is exactly how the COAG Reform Council will operate. As noted, the COAG Reform Council will report on performance information against SPPs outcomes, and will assess whether performance benchmarks have been achieved under National Partnership agreements. The COAG Reform Council's functions are thus similar to the former system for national competition policy whereby the Commonwealth made payments to the states in return for the states implementing competition reform. In that case, an independent body—the National Competition Council—assessed whether the states had undertaken agreed reforms. However, the scope of the COAG Reform Council's powers is unknown, for example, whether the COAG Reform Council will be empowered to recommend the withholding of National Partnership reward payments from a state if it fails to implement reform—as was the case with the National Competition Council. Other major unknowns are how the level of reward payments will be determined, and how they will be allocated among the states.

The new framework leaves untouched reform of the existing arrangements for vertical fiscal imbalance and horizontal fiscal equalisation. While this is not the place to address these issues, a fuller reform of Commonwealth-state financial relations would take them into account. The fact that vertical fiscal imbalance and horizontal fiscal equalisation are not addressed is, however, not surprising: successive governments of different political persuasions have been unwilling to change them.

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16. V. Koutsogeorgopoulou, *Fiscal Relations Across Levels of Government in Australia,* OECD Economics Department Working paper, no. 541, 23 January 2007, p. 31 at: http://www.olis.oecd.org/olis/2007doc.nsf/LinkTo/NT000009EA/$FILE/JT03220724.PDF. Accessed 3 November 2008.

The financing of the three investment funds is under a cloud. A feature of all three is that they are to be partly financed from Budget surpluses. But with the downturn in the economy, the prospect for Budget surpluses is unclear. The Mid-year Economic and Fiscal Outlook 2008-09, which was released on 5 November 2008, projects reduced surpluses. Estimated payments to the states for 2008-09 to 2011-12 are in Attachment D of the Mid-year Economic and Fiscal Outlook 2008-09.

Finally, while the government claims that the new framework will provide greater funding certainty for the states, it is unlikely that the states will stop complaining about the level of Commonwealth funding.

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