

19 March 2008

The Secretary  
Senate Standing Finance and Public Administration  
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Parliament House  
Canberra ACT 2600

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Business  
Council of  
Australia



Dear Sir/Madam

## **FEDERAL-STATE GOVERNMENT FINANCIAL MANAGEMENT**

The Business Council of Australia (**BCA**) welcomes the opportunity to make a submission to the Senate Select Committee on State Government Financial Management's inquiry into Commonwealth and state and territory fiscal relations and state and territory government financial management.

The BCA represents the Chief Executives of 100 of Australia's leading companies. The BCA develops and advocates, on behalf of its Members, public policy reform that positions Australia as a strong and vibrant economy and society. The businesses that the BCA Members represent are among Australia's largest employers and represent a substantial share of Australia's domestic and export activity. Therefore, they have a significant interest in the scope and direction of economic reform.

The BCA has developed a comprehensive policy reform agenda designed to sustain strong economic growth and prosperity based around a vibrant and competitive business sector. As such the BCA has a direct interest in reforms that enable businesses to be more flexible and responsive and that make the economy more competitive.

The BCA comments on the following terms of reference in detail below:

1. Commonwealth funding to the states and territories – historic, current and projected
2. The level of investment in infrastructure and state-owned utilities by state and territory governments AND present and future ownership structures of current and former state-owned utilities and the impact of ownership on investment capacity

## **1. Commonwealth funding to the states and territories – historic, current and projected**

In its report *Reshaping Australia's Federation: A new contract for federal-state relations*, October 2006 (attached),<sup>1</sup> the BCA highlighted that reforms to federal-state funding arrangements are required to ensure a prosperous Australia. Problems with the fiscal arrangements in Australia essentially arise from the imbalance between spending responsibilities and revenue raising capacity. In its report, the BCA identifies the problems associated with this vertical fiscal imbalance (VFI):<sup>2</sup>

*VFI results in the need for the Commonwealth government to transfer funds to State governments to make up for their revenue shortfalls. The problem with such transfers is that accountability between the raising of revenue and responsibilities for funding certain programs can become blurred. For example, the Commonwealth can avoid accountability for expenditure of funds, because the states have a lot of responsibility for a lot of the expenditure. Similarly, states can either become unable to provide certain services through a lack of revenue raising capabilities, or alternatively they can claim they cannot provide such services due to a lack of funding from the Commonwealth. Ensuring that revenue raising abilities and expenditure abilities are aligned may increase the chances of accountability for levels of governments in reaching their commitments.*

Australia's intergovernmental fiscal arrangements have performed poorly. In a 2006 report by Neil Warren for the New South Wales Government *Benchmarking Australia's Intergovernmental Fiscal Arrangements* it was concluded that:<sup>3</sup>

*Australia performs comparatively poorly in intergovernmental fiscal arrangements....Australia's system of intergovernmental fiscal arrangements is characterised by very high vertical fiscal imbalance (VFI) due to inadequate State tax powers, and complex and high level equalisation.*

In effect, a considerable analysis of potential reform priorities to improve the fiscal system in Australia is essential. Some of the key issues relating to Australia's fiscal system are briefly discussed below, however the complexity of such analysis means that all issues associated with federal-state fiscal arrangements will not be discussed in this document.

### **Revenue raising**

In a study of international federations, Australia was found to have the 'most acute case of VFI',<sup>4</sup> due to historical governmental, constitutional and judicial circumstances. The flexibility for states to impose taxes is limited, and often limited towards inefficient taxes which ultimately cost the economy. As a result, Australia has a highly complex and inefficient revenue raising system.

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<sup>1</sup> See Appendix 1, Part 8 Intergovernmental Fiscal Arrangements, pp.43 - 58

<sup>2</sup> See BCA, *Reshaping Australia's Federation: A new contract for federal-state relations*, October 2006, Appendix 1, p.47

<sup>3</sup> Neil Warren *Benchmarking Australia's Intergovernmental Fiscal Arrangements*, New South Wales Government, Final Report, May 2006

<sup>4</sup> TO Hueglin & A Fenna, *Comparative Federalism: A Systematic Inquiry*, Broadview Press, Canada, 2006, p.327

In its survey on business taxes in Australia, *Tax Nation: Business Taxes and the Federal-State Divide*, April 2007 (attached), the BCA highlighted that:<sup>5</sup>

*Australia's intergovernmental fiscal arrangements, having developed in an incremental and often ad hoc manner over time, now give rise to significant complexity and inefficiency. This creates an additional weight Australian businesses must carry as they seek to compete with the world's best.*

The results of the BCA survey found that:

- Businesses in Australia either bear or collect a total of 56 separate taxes – more than double the number identified in the United Kingdom (an economy almost three times the size of the Australian economy).
- Of the 51 taxes directly borne by business, just one – corporate income tax – accounted for two thirds of the total tax raised. The remaining one-third was raised through a complex array of 50 additional taxes.
- Of the 51 taxes borne, the 16 federal taxes accounted for 83 per cent of revenue raised, while the remaining 35 state, territory and local taxes accounted for just 17 per cent.

The survey recommended that the Productivity Commission review the effectiveness of Australia's business tax system, including an assessment of federal and state taxes and for the Productivity Commission to recommend reforms to the system.

In light of the questions of complexity and efficiency raised by the survey results, and the looming fiscal pressures associated with population ageing, a major rethink of tax arrangements, including major sources of revenue as well as revenue-sharing agreements between state and federal governments, cannot be avoided. A range of other recent research supports this view.<sup>6</sup> Likewise, the impact of current tax arrangements on the ongoing competitiveness and vibrancy of Australia's business sector, and therefore the long-term security of revenue sources, needs to be considered.

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<sup>5</sup> See BCA, *Tax Nation: Business Taxes and the Federal-State Divide*, April 2007, p.ii

<sup>6</sup> See for example R. Carling, *State Taxation and Fiscal Federalism: A Blueprint for Further Reform*, CIS Policy Monograph 73, The Centre for Independent Studies, Sydney, 2006. Additional and more general calls for reform include P. Burn, *How Highly Taxed Are We? The Level and Composition of Taxation in Australia and the OECD*, CIS Policy Monograph 67, The Centre for Independent Studies, Sydney, 2005; Ernst & Young, *Taxation of Investment in Australia: The Need for Ongoing Reform*, February 2006; and N. Gruen, *Tax Cuts to Compete: The Influence of Corporate Taxation on Australia's Economic Growth*, Lateral Economics/CEDA Information Paper 85, Committee for Economic Development of Australia, Melbourne, October 2006

## Spending

The pattern of spending responsibilities in federations is determined over time by constitutional and historical circumstances. Neil Warren found in his 2006 analysis that there are some fundamental areas of the Australian economy where the pattern of spending responsibilities differs from other federations. The differences arise particularly in health and education spending and are likely to result in an increased likelihood of policy duplication and blame shifting.<sup>7</sup> Whilst other countries have shared spending responsibilities, Neil Warren found that the:

*Lack of transparency appears to be less problematic where state governments have relatively high levels of fiscal autonomy, as in Canada and the USA.<sup>8</sup>*

The BCA in its Budget Submission 2008-09 (attached) found that governments need to focus on enhancing the capacity of the economy to grow through supply-side policies. Education, health and infrastructure are all vital to increasing participation and productivity, and are all areas characterised by a high degree of overlap and duplication in spending responsibilities across federal and state jurisdictions.<sup>9</sup>

Specific purpose payments, being payments to the states with conditions attached to them, should be used to pursue national objectives consistently across states and territories. However, the BCA has highlighted that SPPs have a number of significant weaknesses because they are:<sup>10</sup>

- Focused on inputs and processes, not outcomes
- Bureaucratic and administratively cumbersome
- A barrier to innovation and efficiency in service delivery
- A source of dispute and tension – not an effective tool for collaboration and partnership
- Sometimes used to address issues that have little to do with core national policy objectives

SPPs should only be used where there is a genuine economic benefit, and where there is a clear and significant national policy objective. Consideration should be given to how their effectiveness can be improved, especially through a greater focus on outcomes, simplicity and flexibility.

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<sup>7</sup> Neil Warren, p.36

<sup>8</sup> Neil Warren, p.47

<sup>9</sup> BCA Budget Submission 2008-09, p.23

<sup>10</sup> BCA Budget Submission 2008-09, p.24

...immediate steps should be taken to reform federal payments to the states to improve simplicity and accountability, reduce administrative costs and reward innovation and efficiency in service delivery.

These steps would provide the foundation for a broader review of federal-state fiscal relations focusing on the overall effectiveness of current revenue raising streams and revenue sharing arrangements, namely:

- the amount of revenue raised
- the operating costs of individual taxes relative to the revenue raised;
- the administrative burden on both government and business of individual taxes; and
- the sustainability of current arrangements

Source: BCA Budget Submission 2008-09, p.23

The BCA supports the recent proposal by the Commonwealth Government to reform specific purpose payments<sup>11</sup>, but believes that SPPs need to be assessed as part of a consideration of the fiscal system in its entirety, including revenue raising, equalisation arrangements and spending arrangements.

There needs to be a better understanding of the sources and magnitude of total funding for service delivery in key areas such as health and education, coupled with clearer allocation of responsibilities in these areas across jurisdictions. In research for the BCA, Access Economics have also highlighted the limitations associated with the existing Commonwealth Grants Commission processes (eg the way in which grants, including the relative distribution of GST revenues, are made across the states and territories and have a potential to reward those states and territories that do not lift their performance and service delivery).<sup>12</sup>

## ***2. The level of investment in infrastructure and state-owned utilities by state and territory governments AND Present and future ownership structures of current and former state-owned utilities and the impact of ownership on investment capacity***

Whilst infrastructure such as ports, road and rail transport systems, water, energy and accessible and fast broadband are the essential building blocks for Australia's future prosperity, our economy has expanded beyond the required infrastructure capacity. Detail on the problems in these key sectors and the reform solutions are outlined in the October 2007 BCA paper *Infrastructure: Roadmap for Reform* (attached for information).

Reforms in these vital areas can have very large potential benefits. In its February 2007 report, *Potential Benefits of the National Reform Agenda*, the Productivity Commission found that further, quite specific reforms in only energy and transport (not water or communications, and excluding urban congestion issues) could boost

<sup>11</sup>The Hon Wayne Swan MP, *Treasurers Advance the Commonwealth-State Reform Agenda*, Media Release No.014, 14/03/2008

<sup>12</sup> BCA Budget Submission 2008-09, p.24

GDP by 0.43% per annum. With this as a starting point, and building on previous work, the reforms outlined in the BCA paper prepared by Mr Rod Sims for the BCA were predicted as potentially boosting GDP by around 2%, or \$20 billion per annum.<sup>13</sup>

As noted in the 2007 BCA paper *Infrastructure: Roadmap for Reform*:<sup>14</sup>

*Success requires a well-functioning federal system, which we do not currently have. COAG meets infrequently, there is little current focus on timelines for concrete action and there is insufficient emphasis on outcomes. In addition, with the end of competition policy payments to the states, the Commonwealth has lost a practical mechanism to drive reform. The BCA has outlined the need for a well-functioning federal system where responsibilities are clearly allocated across the different levels of government, and where COAG meets regularly with a clear work program.*

The OECD in its *Economic Survey of Australia 2005* stated that:

*Infrastructure has held back export growth in some cases...There is still further business in the reform of network (eg electricity, transport, communications) industries and inefficient use of water remains a major concern...Co-operation between the Federal and State Governments will be crucial...*<sup>15</sup>

More recently the OECD commented in its publication *Going for Growth 2008* on Australia's reform progress based on the 2007 priorities that the OECD has set for Australia. The OECD in 2007 had recommended that Australia stimulate competition and efficiency in infrastructure sectors, by: establishing a uniform national regulation for the interstate rail network and reinforcing the competitive neutrality between rail and road transportation; the retail electricity price regulation for households be removed and the producers still owned by the states be privatised; and the reform of the water sector be accelerated.<sup>16</sup>

The OECD highlighted in its 2008 report that the Council of Australian Governments (COAG) agreed to implement uniform national rail safety regulation. With a view to enhancing the national energy market COAG agreed to establish a national operator for both electricity and gas with new national transmission planning functions. COAG also encouraged the states still controlling enterprises in the electricity sector to privatise them. A reform to enhance the management of the main Australian hydraulic basin (the Murray Darling Basin) was adopted.<sup>17</sup>

As already highlighted, there have been longstanding problems with each sector, and these are identified in detail in the BCA paper *Infrastructure: Roadmap for Reform*. However, what is clear is that whilst there have been many commitments made at COAG, very little action has actually been achieved. In essence, reform is

<sup>13</sup> Paper produced for the BCA by Rod Sims *Revitalising Infrastructure Reform* contained in BCA, *Infrastructure: Roadmap for Reform*, October 2007, p.5

<sup>14</sup> Paper produced for the BCA by Rod Sims *Revitalising Infrastructure Reform* contained in BCA, *Infrastructure: Roadmap for Reform*, October 2007, p.3

<sup>15</sup> OECD in its *Economic Survey of Australia 2005*

<sup>16</sup> OECD, *Going for Growth 2008*, p 30

<sup>17</sup> OECD, *Going for Growth 2008*, p 30

not possible unless we have a much more effective working relationship between the commonwealth and state governments.

The BCA paper *Infrastructure: Roadmap for Reform* outlined the foundation strategies for Australia's infrastructure (see the box below).<sup>18</sup>

<ol style="list-style-type: none"> <li>1. Effective national (not state-based) infrastructure markets, including national or uniform regulation</li> <li>2. Market-based prices that send the appropriate signals to consumers and suppliers (cover long-run marginal costs, reflect time of use)</li> <li>3. Public investment processes that are integrated across governments, forward looking, based on consideration of all options and favour projects with the highest (and published) benefit cost ratios</li> <li>4. Effective competition in all contestable (non-network) market segments</li> <li>5. Private ownership as the preferred model in all contestable market segments</li> <li>6. Regulation of infrastructure that does not discourage investment seeking to meet expected demand</li> </ol>	<p><b>Key Enabler</b></p> <p>Effectively functioning Commonwealth-state relations through COAG or other national institution</p> <p><b>Review Mechanism</b></p> <p>Policy and condition audits to be conducted by the Productivity Commission every two years</p>
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## Conclusion

The BCA considers that federal and state governments have a responsibility to achieve greater cooperation in federal-state fiscal and infrastructure arrangements, to ensure that deadweight costs are reduced and to create greater transparency and accountability for investment, spending and revenue raising.

The BCA has found that a major barrier to reform in areas such as SPPs, state government financial management and infrastructure are associated with poor cooperation between governments within our federal system. The need to improve federal-state relations to reduce duplication and ensure governments work together to address issues of national importance is critical for Australia's long-term prosperity.

<sup>18</sup> Paper produced for the BCA by Rod Sims *Revitalising Infrastructure Reform* contained in BCA, *Infrastructure: Roadmap for Reform*, October 2007, p.3

With that in mind the BCA released *A Charter for New Federalism* in December 2007, calling on the nation's political leaders to agree to implement a charter to strengthen and embed improved federal-state cooperation and reforms. The charter should be a formal agreement between the Prime Minister, state premiers and chief ministers. It should commit leaders to working cooperatively through COAG to deliver national reforms and outline new processes and arrangements to lock in improved collaboration and accountability for outcomes.

We attach copies of the following BCA publications for your information:

- BCA Budget Submission 2008-09, February 2008
- *A Charter for New Federalism*, December 2007
- *Infrastructure: Roadmap for Reform*, October 2007
- *Tax Nation: Business Taxes and the Federal-State Divide*, April 2007
- *Reshaping Australia's Federation: A New Contract for Federal-State Relations*, October 2006

If you have any questions or require any further information, please contact me on (03) 8664 2604 or Ms Leanne Edwards on (03) 8664 2614.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Allesandra Fabro', with a stylized, cursive script.

Allesandra Fabro  
Director Policy