Reforming financial relations - improving the quality and effectiveness of government services

Keynote Address to the Intergovernmental Relations 2009 Conference

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INTRODUCTION

[Slide 1 – Title]

My topic this morning is reforming financial relations between the Commonwealth and the States. While this topic may seem a little dry, the reforms have an important underlying purpose that touches all Australians.

For the objective of the reforms agreed last year is to improve the quality and effectiveness of government services in health, education, social housing, disabilities etc.

I shall focus my remarks on the new framework for federal financial relations and the Commonwealth-State aspects of the Australia's Future Tax System (AFTS) review. Both exercises provide significant opportunities to improve the wellbeing of all Australians.

New framework for federal financial relations

[Slide 2 – New framework for federal financial relations]

Last year, the Council of Australian Governments (COAG) committed to the most significant reform of Australia's federal relations in decades. The agreement, which is set out in the new *Intergovernmental Agreement on Federal Financial Relations*[1], provides the overarching framework for the Commonwealth's financial relations with the States and Territories.

The reforms support a new era of collaboration on policy development and service delivery. They provide a solid foundation for far-reaching economic and social reforms in areas of national importance. The framework fosters innovation in service delivery and a positive form of competitive federalism.

[Slide 3 – Four key elements of the new framework]

The new federal financial relations framework has four key elements:

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[1] The agreement is available at http://federalfinancialrelations.gov.au/content/intergovernmental_agreements.aspx

- rationalised and centralised payments;
- performance reporting;
- financial reporting; and
- incentives for reform.

Rationalised and centralised payments

[Slide 4 – Four key elements of the new framework – Rationalised and centralised payments]

The new framework modernises the way payments are made to the States and Territories. Under the framework, policy outcomes and objectives have been separated from funding arrangements to ensure that the policy focus is on achieving better services for all Australians.

By taking a collaborative approach, the new framework gives the States and Territories greater flexibility to direct resources to areas where they will produce the best results in each State and Territory.

Previously, financial controls reduced funding certainty for the States and constrained State and Territory budget flexibility and innovation in service delivery. They also created administrative inefficiencies, as the Commonwealth devoted resources to administering and monitoring processes, and the States and Territories devoted resources to compliance with input controls.

Under the new arrangements, the States and Territories have greater budgetary flexibility in return for greater transparency and accountability. The focus is on mutually-agreed outcomes and outputs, rather than on inputs. And jurisdictions have an incentive to innovate and solve problems at the local level.

Under the new framework, the number of payments for specific purposes has been reduced. The overall quantum of Commonwealth funding to the States has been increased. Previously, each payment for a specific purpose had its own negotiating, administrative and monitoring process. More than 90 specific purpose payments have been rationalised into five new National SPPs for healthcare, schools, skills and workforce development, disabilities services and affordable housing (shown in the slide).

[Slide 5 – Rationalising payments]

The Commonwealth's financial relations with the States now come under the umbrella of one piece of legislation, the *Federal Financial Relations Act 2009*. The streamlined legislation will improve public transparency of these payments and the ability of the Parliament to scrutinise the payment arrangements.

The payment arrangements have also been streamlined. Payments are centrally administered by the Commonwealth Treasury and paid directly to each State and Territory Treasury. Although there are no performance benchmarks associated with National Specific Purpose Payments, States and Territories are required to expend funding in the relevant sector. Each State and Territory will provide a report on expenditure to the Ministerial Council for Federal Financial Relations — the treasurers of all jurisdictions — within six months of the end of the financial year.

Having State and Territory Treasuries distribute Commonwealth funding to their portfolio agencies helps reinforce the fact that State and Territory agencies are primarily accountable to their own parliaments — and, ultimately, the public — for their service delivery.

Performance reporting

[Slide 6 – Four key elements of the new framework – Performance reporting]

As well as rationalising payments, the new framework reinforces the accountability of governments to their own communities for their service delivery through simpler, standardised and more transparent performance reporting by all jurisdictions.

By making performance reporting information publicly available, communities will have access to information about which level of government is accountable for the delivery of a particular service. More importantly, they will have access to information on whether a government's policies and programs are contributing effectively to the desired outcomes; being implemented efficiently; and reaching those people for whom they are intended.

In this way, the performance reporting framework is at the core of the new arrangements.

The COAG Reform Council will provide annual reports to COAG. These reports will contain performance data and provide comparative analysis of the performance of governments in meeting the mutually-agreed objectives.

These reports will also highlight examples of good practice and performance, creating a competitive environment. As a result, over time, innovative reforms or methods of service delivery developed in one jurisdiction may be adopted by other jurisdictions.

Also, to assist the COAG Reform Council, the Productivity Commission will report to COAG every two to three years on the economic impacts and benefits of COAG's reform agenda.

This reporting will cover, as appropriate, the realised and prospective economic impacts and benefits of the different reform streams, including regulation, infrastructure and human capital issues of workforce productivity and participation. Each report to COAG will give priority to informing governments of the nature of reform impacts and benefits and the time scale over which benefits are likely to accrue, given COAG's reform framework and implementation plans. Where information about specific reform impacts or initiatives is limited, the Commission's reporting will produce broad or 'outer envelope' estimates of the potential benefits and costs of reform.

Both the COAG Reform Council and Productivity Commission reports will be publicly available. The media and other commentators will play a role in keeping governments accountable.

The performance reporting framework will rely on the assessment of performance indicators to measure the extent to which objectives, outcomes and outputs are being achieved. Ideally, performance indicators should be ambitious, otherwise there is a risk that benchmarks are set too low and the opportunity to drive reform will be lost.

To support underlying data collection activities, the 2009-10 Budget provided additional funding to data collection agencies, including the Australian Institute of Health and Welfare, the Australian Bureau of Statistics and the National Centre for Vocational Education Research. Funding was also provided to the Productivity Commission to collate this performance information and provide it to the COAG Reform Council for independent assessment.

Also, to support the development of these ambitious reforms a better understanding of the evidence base will also be required in some areas. An example of how governments are working towards a greater understanding is the Indigenous reform agenda. Since December 2007, COAG has made overcoming Indigenous disadvantage a priority and governments have invested substantial additional funds. The National Indigenous Reform Agreement sets out the objectives, outcomes and outputs needed to close the gap in Indigenous disadvantage.

Key to achieving these objectives will be an improved understanding of the evidence base. In part, this will entail addressing data gaps associated with Indigenous related performance indicators. To support improvements in performance reporting, the Commonwealth is providing an additional $46.4 million over four years to fund work undertaken by national data agencies, such as the Australian Bureau of Statistics and the Australian Institute of Health and Welfare as part of the National Integrated Strategy for Closing the Gap in Indigenous Disadvantage.

Financial reporting

[Slide 6 – CLICK – Four key elements of the new framework – Financial reporting]

The Commonwealth Treasury is responsible for the efficient administration of payments to, and through, the States and Territories. These payments cover assistance under the five National Agreements, general revenue assistance payments and assistance under National Partnerships.

The Commonwealth Treasury Portfolio Budget Statements provide detailed information on the new centralised payments, including programs for which Treasury is appropriated under the *Federal Financial Relations Act 2009*.

Incentives for reform

[Slide 6 – CLICK – Four key elements of the new framework – Incentives for reform]

A key aspect of the reforms is National Partnership payments, which act as a mechanism to drive reforms or improve service delivery standards through incentive payments. National Partnership payments are provided to the States to:

- support the delivery of specified outputs or projects;
- facilitate reforms; or
- reward those jurisdictions that deliver on nationally-significant reforms.

These payments have a strong collaborative foundation with each being supported by a National Partnership agreement which defines mutually-agreed objectives, outcomes, outputs and performance benchmarks.

The reward payments encourage the achievement of ambitious performance benchmarks, acting as a driver for reform. They do this by providing incentives to States to improve outcomes through more efficient service delivery and creating a competitive environment, and provide better outcomes than could be achieved without collaboration between governments. Reward payments would not be paid to a jurisdiction until an independent assessment by the COAG Reform Council demonstrates that performance benchmarks have been achieved.

The other types of National Partnership payments — project and facilitation — support the delivery of specific projects by providing funding to the States. Existing payments for specific purposes and election commitments have become National Partnership project payments.

Investments from the Commonwealth's Nation Building Funds that are directed to State and Territory infrastructure projects are also treated as National Partnership payments.

Facilitation payments are used to assist a state or territory to lift standards of service delivery or to encourage the States and Territories to agree to implement ambitious reforms.

The new framework is flexible. Its collaborative approach has enabled the Commonwealth and States and Territories to work together to tackle the global financial crisis and respond quickly to recent economic challenges. The framework has provided the mechanism to allow the Commonwealth and States and Territories to implement elements of the fiscal policy response including the Nation Building and Jobs Plan and the Compact with Young Australians.

Another example of outcomes associated with a National Partnership agreement can be seen in The First Home Owners Boost agreement. This agreement has the following outcomes:

(a) assist first home buyers to enter the housing market; and

(b) provide stimulus to the housing market.

Australia's Future Tax System review

[Slide 7 – Australia's Future Tax System (AFTS) review]

The new framework for federal financial relations committed governments to an ambitious forward-looking agenda based on continuous reform. Previously federal financial relations have changed in an *ad hoc* way, with reforms often designed to support other policy objectives to address a crisis at a particular point in time.

Alongside Commonwealth funding of State and Territory service delivery, the tax system also plays an important role in funding quality public services that benefit individuals as well as the economy more broadly. The new framework recognises further reform of Commonwealth, State and Territory taxes as an integral part of improving federal financial relations.

Tax reform was a large part of the previous *Intergovernmental Agreement on the Reform of Commonwealth-State Financial Relations*, which was signed in 1999. The States agreed to a number of reforms, including abolishing a number of taxes which had been identified as inefficient, and were provided with the ongoing revenue from the goods and services tax (GST) in return. The ongoing GST payments were available for use by the States and Territories for any purpose.

The new framework does not set out a new agenda for tax reform. But further tax reform is consistent with, and complementary to, many of the objectives of the new framework. For this reform, is expressly foreshadowed in the *Intergovernmental Agreement on Federal Financial Relations*.

Improving the design of taxes and the way that they are applied across levels of government can provide all levels of government with sufficient and sustainable revenue. This funds expenditure, provides returns for undertaking reforms, increases transparency, reduces complexity and compliance costs, and enhances the efficiency and equity of the tax system. It is important that both the collection of revenue, via taxes and other charges, and the expenditure of this revenue reinforce these principles. While the new framework has improved the expenditure of revenue, there is still some way to go on in terms of how this revenue is raised.

A recent report, *State business tax reform: seeding the tax reform debate,* which was commissioned by the Business Coalition for Tax Reform (the BCTR)[2], is an important contribution to public debate. The report contained three options for state tax reform which are estimated to increase GDP in the long run by up to 1.7 per cent. Clearly, this is not an insignificant number[3]. Further, it is possible that reforms could be larger than that outlined in the report, which could result in a larger gain to GDP than that estimated.

The Australia's Future Tax System (AFTS) review will look at the current tax system and make recommendations to position Australia to deal with the demographic, social, economic and environmental challenges of the 21st century and enhance Australia's economic and social outcomes. This includes considering State and Territory taxes and the appropriate administrative arrangements for the tax-transfer system across the federation.

[Slide 8 – Chart 1 – Vertical fiscal imbalance since federation]

When considering tax reforms and the federation's administrative arrangements, an important feature of the Australian federation is vertical fiscal imbalance (VFI). VFI results when a level of government has expenditure functions that are not wholly financed through its own assigned revenue sources.

At the recent AFTS tax and transfer policy conference, Professor Richard Bird noted that the current states of affairs in federations are a reflection of each federation's

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[2] The report was undertaken by the Centre for International Economics and can be found at http://www.thecie.com.au/content/publications/BCTR_Final%20report_27_March%2009.pdf

[3] For comparison, in its 2005 *Review of National Competition Policy Reforms*, (Inquiry Report No. 33, Productivity Commission, Canberra, March), pp 36, the Productivity Commission found in its previous quantitative modelling (in 1995 and 1999) that the " 'outer envelope' of potential improvements from implementing NCP reforms yielded estimates of GDP gains in the long term of up to 5.5 per cent."

unique history. In this context, while Australia currently has a high level of VFI when compared to other federations, this has not always been the case (see Chart 1).

So should we worry about VFI being this high? This is a genuinely open question. VFI can have both benefits — through allowing a more efficient and simpler tax system — and costs — stemming from a possible blurring of accountability[4]. Therefore, the Australian community, through its governments, will need to decide how much VFI is appropriate in the Australian context.

The reforms contained in the 1999 Intergovernmental Agreement highlight this trade-off. There is little doubt that the abolition of a range of inefficient taxes (both Commonwealth and State) and replacing them with the GST increased the efficiency of Australia's tax system. On the other hand, the States and Territories had taxes which they had complete control over replaced with revenue from a tax whose rate and base can be changed only with unanimous agreement of nine governments. This resulted in an increase in measured VFI.

There are mechanisms which can allow the federation to minimise the costs of this trade-off, particularly in relation to taxation arrangements. It does not have to be the case that the same level of government undertakes all three functions of tax policy in a federal system — design, administration and distribution of revenue. Indeed, with intergovernmental cooperation, arrangements can help to minimise the costs associated with taxation in a federal system.

For example, an option raised at the recent AFTS conference was that the States could be allowed to vary rates of centrally administered tax bases. Such an arrangement might reduce tax base erosion, and make it easier for businesses to understand and comply with their obligations, while still providing the States and Territories with the flexibility to respond to jurisdiction-specific preferences. As the

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[4] For more information on these costs and benefits see Chapter 10 of *Australia's future tax system: architecture of Australia's tax and transfer system*, which can be found at http://taxreview.treasury.gov.au/content/Paper.aspx?doc=html/Publications/papers/report/index.htm

new framework for federal financial relations highlights, moving to a new set of arrangements can be challenging, however, the rewards for overcoming such challenges are potentially large.

Last December, the tax review panel identified a number of broad issues to frame consideration of Australia's future tax-transfer system[5]. Three of those issues – increasing globalisation, demographic change and the role of technology — are particularly relevant to State and Territory finances.

Globalisation means economic activities across countries are becoming increasingly integrated and government tax bases are becoming more mobile.

Demographic change will affect different (federal, state and local) tax bases and expenditure in different ways. These pressures will influence federal financial relations.

Emerging technologies have the potential to redefine the way we design and administer the tax-transfer system, with significant implications for both compliance and operating costs.

Theory can also assist in assigning tax functions appropriately between levels of governments. As Ken Henry recently outlined[6] "the theory of tax assignment, developed by Richard Musgrave and others suggests that in a federal system, lower level jurisdictions should avoid using taxes for the purposes of income redistribution and macroeconomic stabilisation. These functions are more appropriately assigned to the national level." Also, theory suggests that, in general, lower level jurisdictions should avoid tax bases which are mobile between jurisdictions.

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[5] For more information see the Australia's Future Tax System, Consultation paper, December 2008 available at http://www.taxreview.treasury.gov.au/content/ConsultationPaper.aspx?doc=html/Publications/Papers/Consultation_Paper/index.htm

[6] For further detail see Dr Ken Henry's speech on 27th March 2009 at the 2009 Commissioners' Conference in Sydney available at http://taxreview.treasury.gov.au/Content/Content.aspx?doc=html/speeches/04.htm

Recent experience in Commonwealth-State relations augurs well for further tax reform.

The AFTS review provides a good opportunity to continue the reform of federal financial relations if governments work collaboratively. I, like the rest of you, will be interested to see where the review panel settles on the significant issues surrounding intergovernmental relations.

But there is still work to be done

[Slide 9 – But there is still work to be done]

The new financial relations framework has been the catalyst for a major cultural shift for both the Commonwealth, and the States and Territories. It will take time for all jurisdictions to adjust to the new arrangements and maximise their potential. Moreover, there is considerable work remaining to deliver on the outcomes envisaged.

As with all new systems, the detail of the framework will need refining with the experience of implementation. This is likely to involve:

- improving data sources to align them with performance indicators;
- refining performance indicators to align them more closely to desired outcomes;
- changing the mix of funding, such as greater use of reward payments over facilitation payments in National Partnerships to encourage improvements in service delivery models; and
- considering additional service delivery areas under National Agreements and National Partnerships as government priorities change.

Importantly, the effectiveness of the new framework depends on informed public debate about performance. How governments, stakeholders and commentators utilise the COAG Reform Council's and Productivity Commission's reports will be an important factor.

Many of the National Partnerships set outcomes which focus on nationally consistent approaches to areas of national importance, for example the Seamless National Economy National Partnership. It will remain important that this national consistency in not lost in the implementation process.

The development of the new performance reporting framework also provides an opportunity to move, as far as possible, to a single, integrated national reporting system that will reduce collection costs and confusion in interpreting government performance.

This ambitious goal set by COAG is being overseen by the Ministerial Council for Federal Financial Relations. In the short term, the Ministerial Council is focussing on the implementation of the performance reporting framework including the indicators associated with National Agreements and National Partnerships.

The global recession is significantly affecting the Australian economy and increasing the fiscal challenges for all levels of government. Notwithstanding these conditions, it remains important for all levels of government to continue to implement reforms in priority areas, while ensuring fiscal sustainability over the medium term.

One area where COAG has spent less time in the past 18 months, is considering changes to roles and responsibilities. Properly implemented, the new framework should the sharpen focus.

The new framework would be complemented by effective tax reform at both the Commonwealth, and the State and Territory levels. The AFTS review provides an opportunity for such tax reform to occur. All levels of government should gain from further tax reform. Experience suggests that successful implementation of state tax reforms will require effective cooperation and coordination between the Commonwealth and the States and Territories.

Concluding comments

Last November, COAG agreed to the most significant reform of Australia's federal relations in decades. The framework provides a robust foundation for collaboration on policy development and service delivery and facilitates the implementation of economic and social reforms. As part of this, the States and Territories have been provided with more budget flexibility, greater funding certainty and an overall increase in the amount of funding. In return, they have agreed to greater transparency and accountability.

The AFTS review provides a timely opportunity to position the taxation system for the decades ahead, including enhancing Australia's economic and social outcomes. It is likely to make recommendations to improve further the efficiency and effectiveness of the national tax system and to enhance the sustainability of financial arrangements across the federation.

Our challenge is to ensure these reforms deliver the outcomes intended — the delivery of better services for the community and a tax system well positioned for the 21st century.