# Victorian Budget

## 2012-13 Federal Financial Relations

**Budget Information Paper No. 3**

The Secretary
Department of Treasury and Finance
1 Treasury Place
Melbourne, Victoria, 3002
Australia

Telephone: +61 3 9651 5111
Facsimile: +61 3 9651 5298
Website: www.budget.vic.gov.au

Authorised by the Victorian Government
1 Treasury Place, Melbourne, 3002

Printed managed by Finsbury Green,
Level 9, 124 Exhibition Street, Melbourne 3000

This publication makes reference to the
2012-13 Budget Paper set which includes:
Budget Paper No. 1 – Treasurer's Speech
Budget Paper No. 2 – Strategy and Outlook
Budget Paper No. 3 – Service Delivery
Budget Paper No. 4 – State Capital Program
Budget Paper No. 5 – Statement of Finances
(incorporating Quarterly Financial Report No. 3)



ISSN 1440-6969

Published May 2012

Printed on recycled paper

# Victorian Budget

# 2012-13 Federal Financial Relations

**Budget Information Paper No. 3**

# TABLE OF CONTENTS

# FEDERAL FINANCIAL RELATIONS

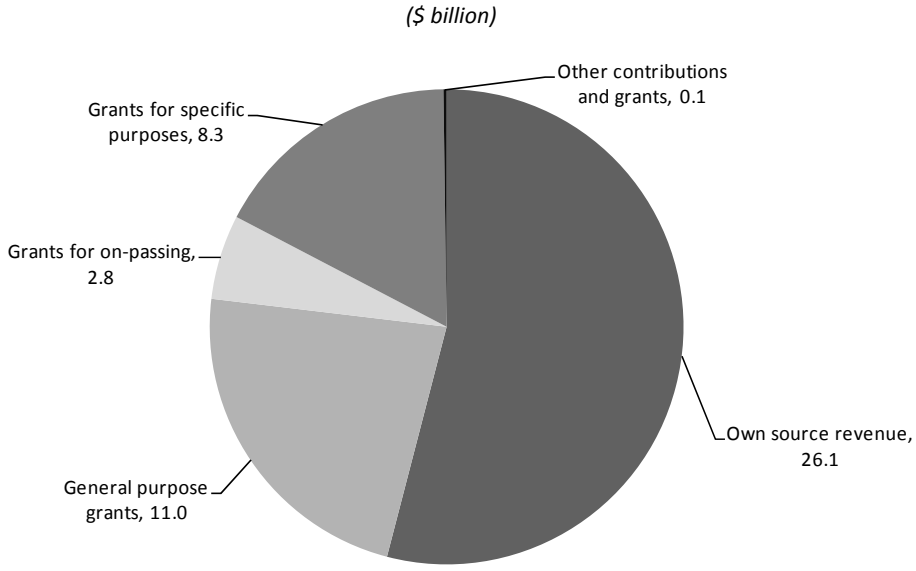
- Victoria has consistently received less than its population share of Commonwealth grants. Over the past decade Victorians have received less revenue from Commonwealth grants per capita than any other state.
- Victoria has lost $6.1 billion in forecast goods and services tax (GST) revenue from 2012-13 to 2015-16 compared to forecasts in late 2010. This is a result of lower GST pool growth and Victoria's reduced GST revenue sharing relativity.
  - For example, in the 2012-13 year forecast GST revenue has been lowered by $1.1 billion due to a weaker national pool and $450 million due to Victoria's revised relativity.
- The modern Australian federation needs a GST distribution system that is simple, fair, efficient and transparent. The current formula for the distribution of GST revenue is unpredictable, overly complex and rewards inefficiency. It is illogical that Victoria has the second lowest relativity among the states in the middle of a mining boom.
  - An equal per capita share of GST would mean approximately $900 million in additional revenue for Victoria in 2012-13.
- National Partnership agreements have allowed the Commonwealth and Victoria to jointly deliver projects and reforms of Victorian and national significance. A number of these agreements are approaching expiry or are otherwise uncertain. These uncertain payments have provided funding of some $2.4 billion to Victoria since 2008-09. Non-renewal of these agreements will result in a reduction in service delivery to the Victorian community.
- The *2008 Intergovernmental Agreement on Federal Financial Relations* was a significant reform which included a rationalisation of Commonwealth grants to the states. However, Commonwealth grants have proliferated again over the last three years. Many of these also involve prescriptive input controls, adding to red tape and undermining efficiency.
- In a range of areas, the Commonwealth Government's push for uniformity undermines flexibility, innovation and responsiveness at the local level.
- A properly working federation requires an appropriate balance between competition and cooperation. Future directions for the Australian federation should seek to promote those aspects which have served the nation well for more than 100 years.

## 1. THE IMPORTANCE OF FEDERAL FINANCIAL RELATIONS

Federal financial relations are of fundamental importance to state and territory budgets. The Australian federation is characterised by a significant imbalance between the revenue raising capacity of the Commonwealth and state governments and their respective service delivery responsibilities, known as vertical fiscal imbalance (VFI – see Appendix A). It is in recognition of this imbalance that the Commonwealth provides funding to states.

In 2012-13, Victoria will obtain 46 per cent of its total revenue from Commonwealth grants, around half of which is GST revenue. The size and predictability of these Commonwealth transfers and the conditions placed on them materially impact on the formulation of the Victorian budget.

**Chart 1: Sources of revenue for Victoria 2012-13**




*Source: Department of Treasury and Finance*

The broader conduct of Commonwealth–state relations has wider implications for national economic policy and the ability of states and territories (states) to govern on behalf of their local communities.

As a result, the Victorian Government has produced a Budget Information Paper specifically devoted to federal financial relations. It serves to:

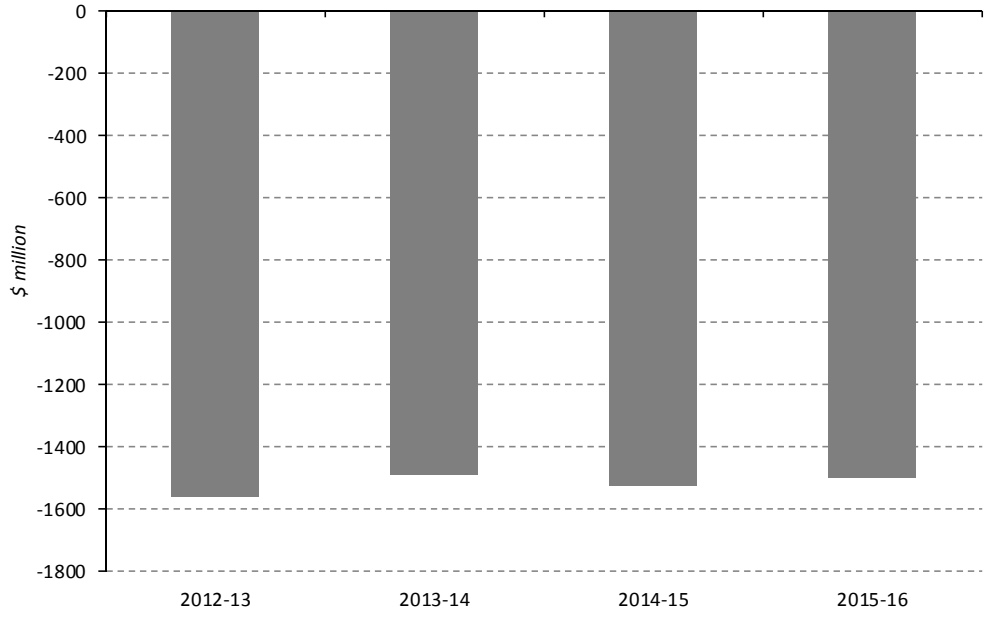
- identify trends in revenue from the Commonwealth Government;
- examine aspects of Commonwealth–state relations which are relevant to the management of resources, service delivery and broader policy; and
- outline Victoria's position in relation to the smooth working of the federation for the collective benefit of all Australians.

## State revenue challenges

The Australian economy is undergoing significant structural change, reflecting the impact of major global economic transitions currently underway. The rising economic power of emerging economies is resulting in high commodity prices, a shift in private investment towards resource and energy projects and a historically high Australian dollar.

To compound these issues, Victoria has lost significant forecast GST revenue since late 2010, resulting both from a shrinking of the national pool and a 2011 reduction in its share (Chart 2). This has cut $6.1 billion from Victoria's budget from 2012-13 to 2015-16 compared to forecasts in late 2010. Economic conditions have also led to a decline in expected own source taxation revenue.

**Chart 2: Downward revisions to forecast Victorian GST revenue since *2010-11 Budget Update***

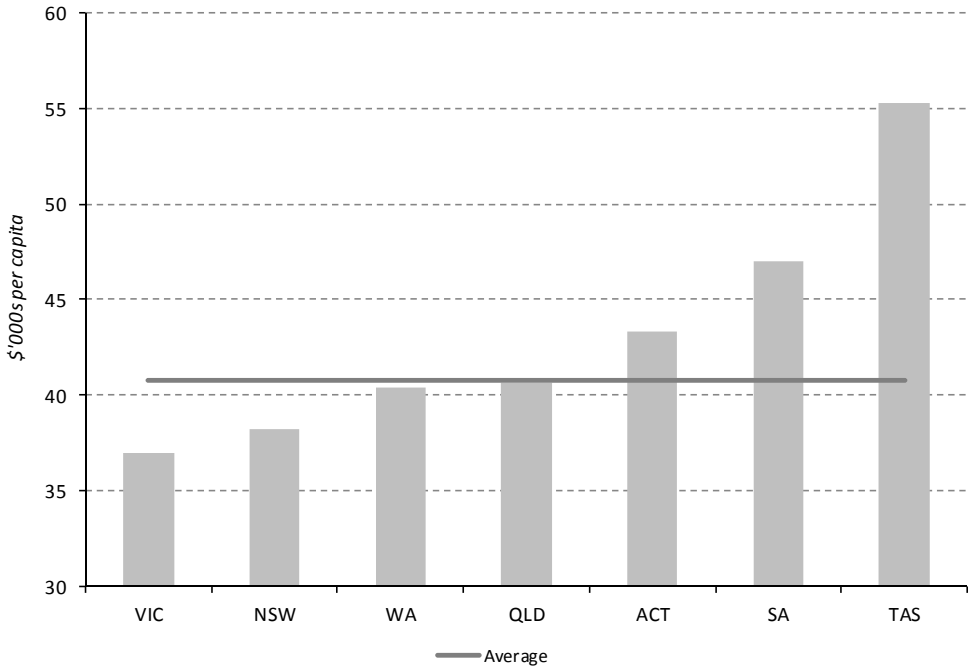



*Source: Department of Treasury and Finance*

In addition, the future of a large number of National Partnerships remains uncertain, despite their importance to service delivery outcomes.

Moreover, as illustrated in Chart 3, Victoria has received less Commonwealth funding per capita than any other state over the past decade.

**Chart 3: Total per capita Commonwealth grants 2000-01 to 2011-12**




*Source: Department of Treasury and Finance*

*Note: The Northern Territory has been excluded for presentation purposes. The Northern Territory received $137 700 per capita over this period.*

To manage our current economic challenges and maximise opportunities, Australia's Commonwealth–state arrangements must provide flexibility, encourage efficiency and competition and ensure stability and predictability.

The current system of federal transfers creates additional uncertainty in a policy environment already made challenging by the size and scope of the economic transition underway.

As a non-resource state, Victoria relies heavily on its ability to boost productivity growth in order to create employment and raise living standards. This requires that the Victorian Government has the flexibility to reduce regulatory burdens and improve the State's competitiveness through superior policy settings.

The Victorian Government is committed to working cooperatively in the national interest to ensure the system of federal financial relations fulfils its potential. It will also continue to advocate for a fairer share of Commonwealth transfers for all Victorians.

## 2. THE CHALLENGES CONFRONTING FISCAL FEDERALISM

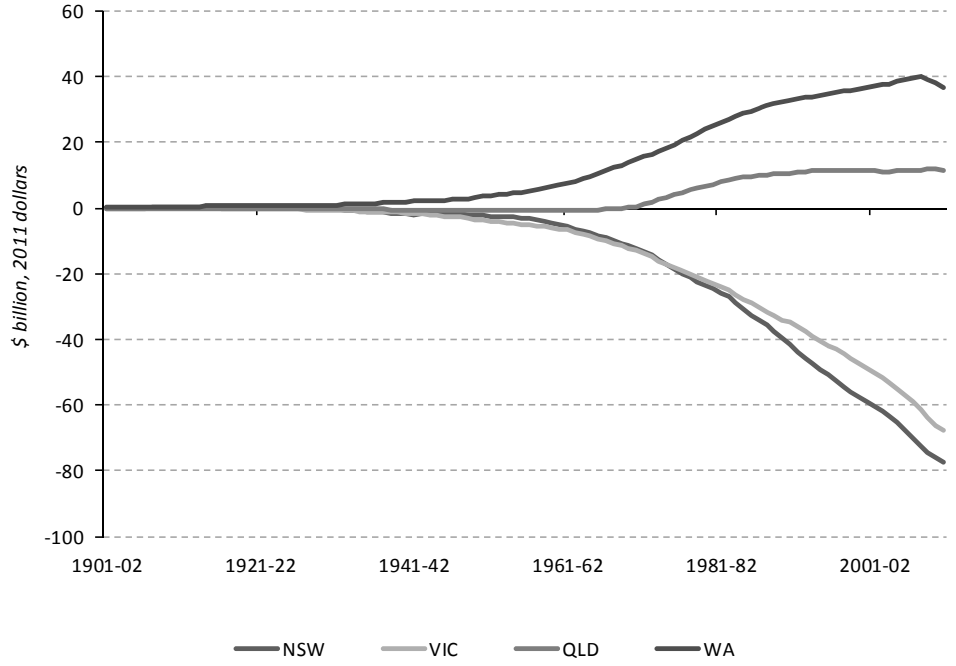
### Untied grants – the GST

Victorian GST revenue is forecast to be $11 042 million in 2012-13 – $635 million less than expected in the *2011-12 Budget Update*. This is the latest in a series of downward revisions to forecast GST revenues, which bring the total loss from 2012-13 to 2015-16 (compared to forecasts in late 2010) to $6.1 billion.

The combination of pool reductions and annual adjustments to relativities results in considerable fluctuations in GST revenue.

Chart 4 shows the redistribution of Commonwealth grants to states relative to a population-based distribution since Federation.

**Chart 4: Cumulative redistribution of Commonwealth grants**




*Source: Department of Treasury and Finance*

In total to 2010-11, Victoria has received $68 billion less in Commonwealth grants in real terms than its equal per capita share of Commonwealth transfers since Federation. Victoria is the only state to have been a net contributor (receiving less than its population share) in every year since 1901.

Like the small states (not shown), Western Australia and Queensland have received more than their per capita share since Federation. They have only become donor states in recent years. These states would not be in a position to capitalise on their current mineral opportunities without the past century of support from Victoria and New South Wales.

### *A complex and unpredictable system of GST distribution*

The GST pool is fully redistributed according to the recommendations of the Commonwealth Grants Commission (CGC), based on the principle of horizontal fiscal equalisation (HFE). Victoria has consistently received significantly less than its population share of the GST pool as a result of the current model of HFE.

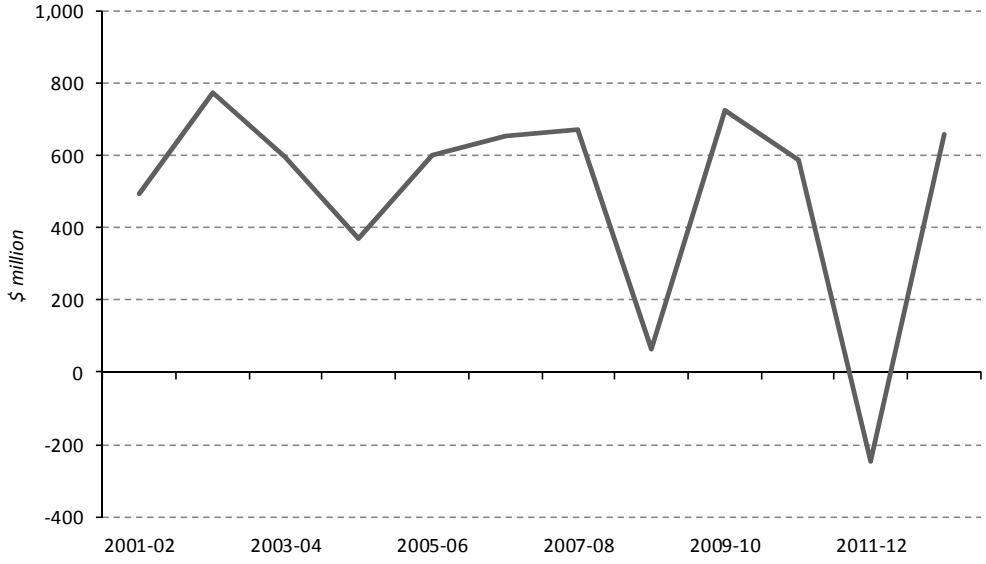
The Victorian Government has significant concerns with the HFE methodology. Despite significant social and economic reform in Australia over the past 100 years and falling interstate income disparities, the method of distributing untied Commonwealth revenue among states has remained largely unchanged. The introduction of the GST was one of the biggest changes to federal financial relations, yet surprisingly it did not result in a new method of funding allocation. All states still rely on a complex system to determine their GST allocations, despite the fact that redistribution now only assists the four smaller recipient jurisdictions (accounting for only around 12 per cent of Australia's total population).

The current methodology is unduly complicated, unpredictable and subjective, and creates perverse incentives. It compensates states for underperformance, penalising those states that implement reforms to reduce service delivery costs and rewarding states that do not.

The combination of the extremely complex and opaque CGC model of HFE and changes in the GST pool[1] make GST revenue volatile and extremely difficult to forecast. Victoria lost more than $400 million in GST revenue in 2011-12 due to changes in our relativity, largely driven by data revisions. Volatility of this size makes GST revenues unreliable and has a significant impact on the ability of states to manage their budgets. Chart 5 shows the volatility of GST payments to Victoria.

1 See further information on changes to the GST pool in Budget Paper No.2.

**Chart 5: Annual change in GST payments to Victoria**




*Source: Department of Treasury and Finance*

For these reasons the Victorian Government called on the Commonwealth Government to undertake a broad review of the system of HFE. The *GST Distribution Review* (discussed on page 8) represents an opportunity to recast HFE to fit a modern federation. To achieve this the review must recommend fundamental reform, designing a system that is simple, sustainable, predictable and transparent, and which supports broader economic and fiscal reform.

### *The GST Distribution Review*

On 30 March 2011, the Commonwealth announced a 'root and branch' review of GST distribution.

The Victorian Government argued that Australia should progress towards a model that distributes GST on an equal per capita (EPC) basis. EPC is the most simple, transparent, stable, and efficient way of distributing the GST. The entrenched policy challenges faced by some states should be supported by the Commonwealth through targeted, tied payments, separate from the GST distribution.

On 23 April 2012 the Commonwealth Government released the interim report of the review panel. The interim report identifies some positive areas for investigation and establishes a useful base for further discussion. Victoria is concerned by proposed changes to the assessment of mining revenues and related infrastructure needs, but is encouraged by proposals for equalisation to comparable rather than the same standard and the exclusion of nationally significant infrastructure grants. The Government will consider the interim report in greater detail and make a further submission to the review.

In November 2011 the Commonwealth issued supplementary terms of reference to the review, which indicate the Commonwealth intends to use the GST distribution to influence state policy on royalties and tax reform.

The Victorian Government strongly opposes any proposal to use the GST distribution to influence state policy and service delivery. Converting any part of the GST to any form of tied revenue would impinge on states' autonomy, and severely reduce their capacity to undertake reforms, plan future investment and respond to changing conditions and local priorities.

## Tied grants

Tied payments are also provided to states in recognition of VFI and are vital for the delivery of core schooling, social housing, vocational education and training and disability services.

As per the *2008 Intergovernmental Agreement on Federal Financial Relations* (2008 IGA), Commonwealth payments to states should be free from prescriptions so that states can respond to the needs of local communities. States' primary accountability is to the public for expenditure and outcomes, rather than to the Commonwealth Government. The 2008 IGA, described at the time as the most significant reform to federal financial relations since the introduction of the GST, is discussed further in Appendix B.

The 2008 IGA established two simplified categories of tied funding:

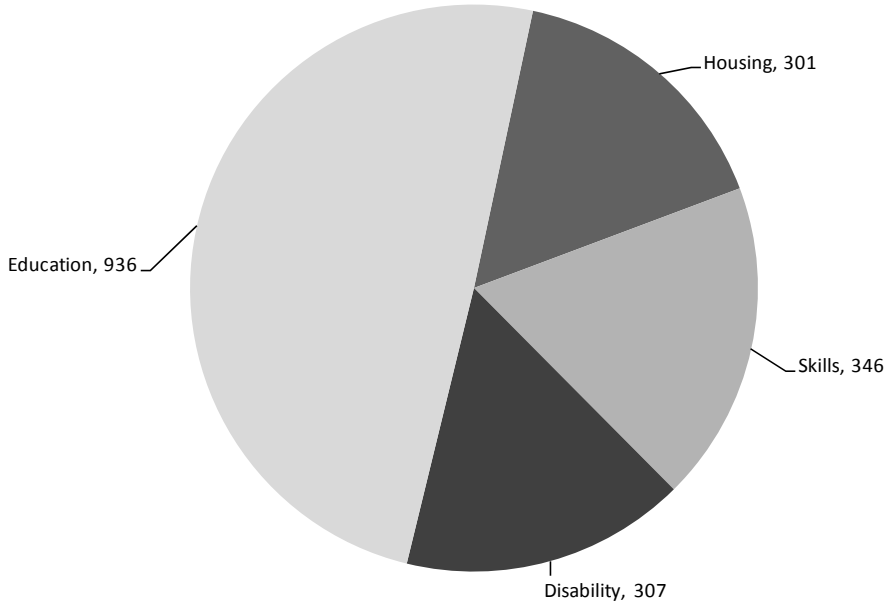
- National Specific Purpose Payments (NSPPs) for ongoing funding; and
- National Partnerships (NPs) for time-limited funding.

### *National Specific Purpose Payments*

NSPPs are ongoing transfers from the Commonwealth to the states, tied only to broad service sectors. There are no specific requirements for how NSPP funding is spent, but states are publically accountable to their constituents through the democratic process, as well as through independent reporting to the Council of Australian Governments (COAG) Reform Council on outcomes. This recognises states' primary constitutional responsibility for service delivery in these areas.

**Chart 6: National Specific Purpose Payments to Victoria by sector 2012-13**

*($ million)*




*Source: Department of Treasury and Finance*

The Healthcare NSPP will expire under the National Health Reform Agreement on 1 July 2012. It will be replaced with more output-focused, activity-based funding arrangements. National (not centralised) governance arrangements for hospital funding administration mean that all funding for public hospitals will stay under state legislative and financial control. The Victorian Government remains wholly responsible to Victorians for the services delivered in Victoria's hospitals.

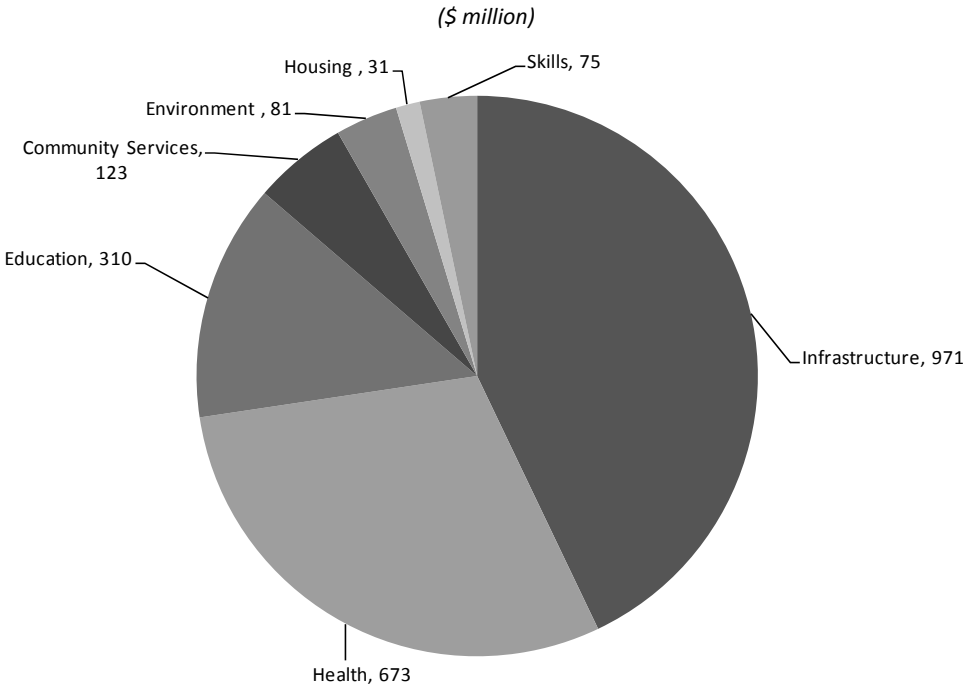
The remaining broad-banded NSPPs should be retained in their current form. The Commonwealth is currently considering school funding reform, including with regard to the recent *Review of Funding for Schooling*. In this context the Victorian Government strongly opposes any changes to the Schools NSPP which constrain its policy or financial flexibility.

### *National Partnership Payments*

NPs are time-limited agreements to support the delivery of specified outputs or projects, or facilitate and reward nationally significant reforms.

States are required to spend NP funding on specified outputs or outcomes. Under the 2008 IGA, NPs are intended to move the focus away from Commonwealth input controls and direct mandating of outputs, and towards states' achievement of mutually agreed outcomes.

**Chart 7: Major National Partnership payments to Victoria by sector 2012-13**




*Source: Department of Teasury and Finance*

Since their inception, NPs have provided a successful vehicle for joint investment in projects and reforms of national significance. They have delivered enhanced outcomes across a range of areas, including improved literacy and numeracy outcomes, improved teacher quality and school leadership.

However, the Victorian Government is concerned that NPs are not being used as effectively as envisaged in the 2008 IGA. Problems include a lack of Commonwealth commitment to ongoing reform, micromanagement of state delivery, a loss of focus on reforms of national significance and increasing red tape and bureaucracy.

These issues are discussed in more detail below.

Victoria is willing to work cooperatively with the Commonwealth and other states to ensure that future NPs provide the flexibility, accountability and reform focus intended by the 2008 IGA.

### *Lack of Commonwealth commitment to ongoing reform – cost shifting*

While some NPs relate to one-off projects or reform actions, many others were essentially policy pilots – new directions in service delivery. The lessons of new ventures were to be evaluated and shared across jurisdictions. Importantly, where these agreements improved the level or quality of service, the 2008 IGA made clear provision for ongoing and flexible funding (as part of a NSPP). In this way the success of reforms would be maintained.

Disappointingly, the Commonwealth has so far refused to seriously engage with states on the future of expiring tied grants. Failure to provide ongoing funding would represent cost shifting by the Commonwealth Government for outcomes and reform directions which were mutually agreed. Given Victoria's limited financial capacity to cover Commonwealth funding shortfalls, Victorians may miss out on the types of services that they have come to expect.

For example, while Victoria welcomes the new Skills Reform NP signed by COAG in April 2012, funding is heavily weighted towards later years and will see Commonwealth NP funding for Victorian skills reform fall from $120 million in 2011-12 to $60 million in each of 2012-13 and 2013-14. This is occurring at a time when demand for training is very strong.

At least six NPs approaching expiry have achieved intended increases in service standards and should be rolled into a relevant NSPP (sector specific, ongoing funding). These are outlined in Table 1. Non-renewal of these agreements will negatively impact on the Victorian community, for example:

- A winding back or cessation of Commonwealth funding for the **Digital Education Revolution NP** would disadvantage future student cohorts because unlike current Year 9 to 12 students they would not receive computers.
- Reduced funding under the **Smarter Schools NP – Improving Teacher Quality Initiative** would see Victoria's teachers not rewarded for delivering better educational outcomes for disadvantaged and Indigenous students and for working in rural/remote and hard-to-staff schools.
- Discontinued funding under the **Hospital and Health Workforce Reform NP** could leave 170 sub-acute care beds across Victoria (59 000 bed days – this represents approximately 2 360 patients that would not receive care) unfunded.

**Table 1: Expiring National Partnerships that should be rolled into a National Specific Purpose Payment**

| *Name* | *Total funding ($ million)*[(a)] | *Expiry* | *Description* |
|---|---|---|---|
| Digital Education Revolution NP | 517 | 30 June 2013 | Funding for new information technology equipment for all secondary schools with students in Years 9 to 12. |
| Smarter Schools[(b)]<br>• Improving Teacher Quality NP<br>• Literacy and Numeracy NP<br>• Low SES School Communities NP | 405 | Various | Funding has been delivered for system initiatives and school level activity to build leadership and teacher capacity, monitoring student performance and family and community partnerships, especially in areas of low socioeconomic status. |
| Homelessness NP | 106 | 30 June 2013 | Funding has raised state and territory service delivery levels and helped support the achievement of long-term reductions in homelessness. |
| Hospital and Health Workforce Reform NP [(c)]<br>• Activity Based Funding<br>• Subacute Care<br>• Taking the Pressure off Public Hospitals | 342 | 30 June 2013 | The NP has delivered improvements to emergency services capacity to treat the increasing number of patients who could otherwise be treated in a primary care setting. |

*Notes:*

*(a) Total funding over the life of the current agreement(s).*

*(b) While components of the Smarter Schools package expire at different points in time, it is appropriate to consider the future of all components at the same time.*

*(c) The increased level of activity under these components of the NP is the starting point for the significant national health reforms being implemented under the National Health Reform Agreement. Ongoing funding is necessary to sustain these increased base levels of services and activities, supporting the next stage of reforms.*

These NPs will provide funding of almost $1.4 billion to Victoria from 2008-09. There are a number of other expiring agreements, amounting to about $1 billion over the same period, that warrant certainty of ongoing funding. Remaining expiring agreements that have served their purpose will appropriately expire.

### *Commonwealth micromanagement*

Detailed Commonwealth Government prescriptions in state service delivery undermine Victoria's ability to tailor implementation to local conditions, reduce the scope for innovation and increase red tape and administrative costs.

Contrary to the clear spirit of the 2008 IGA, the Commonwealth has steadily moved to reintroduce prescriptive input controls into NPs. This appears to represent a shift by the Commonwealth from cooperative federalism to a more coercive approach.

> The IGA represents the most significant reform of Australia's federal financial relations in decades. It is aimed at improving the quality and effectiveness of government services by reducing Commonwealth prescriptions on service delivery by the States, providing them with increased flexibility in the way they deliver services to the Australian people.[2]

A 2010 review of NPs and associated agreements conducted by Commonwealth and state treasuries found that financial controls exist in approximately one third of NPs, and other input controls in approximately one quarter of NPs. States have argued that the proportion of agreements containing input controls is considerably higher than those identified in that review.

As noted by the *Ministerial Council for Federal Financial Relations Report to COAG on the Implementation of the Intergovernmental Agreement*: 'The continued use of input controls is impeding the shift towards giving states and territories greater flexibility in how they deliver outcomes coupled with greater accountability for outcomes.'

### *Proliferation of small agreements*

The 2008 IGA was intended to reduce both the number and complexity of agreements between the states and the Commonwealth. In doing so it sought to focus governments' interaction on reforms of national significance, and to reduce the administrative overheads and constraints on state decision making.

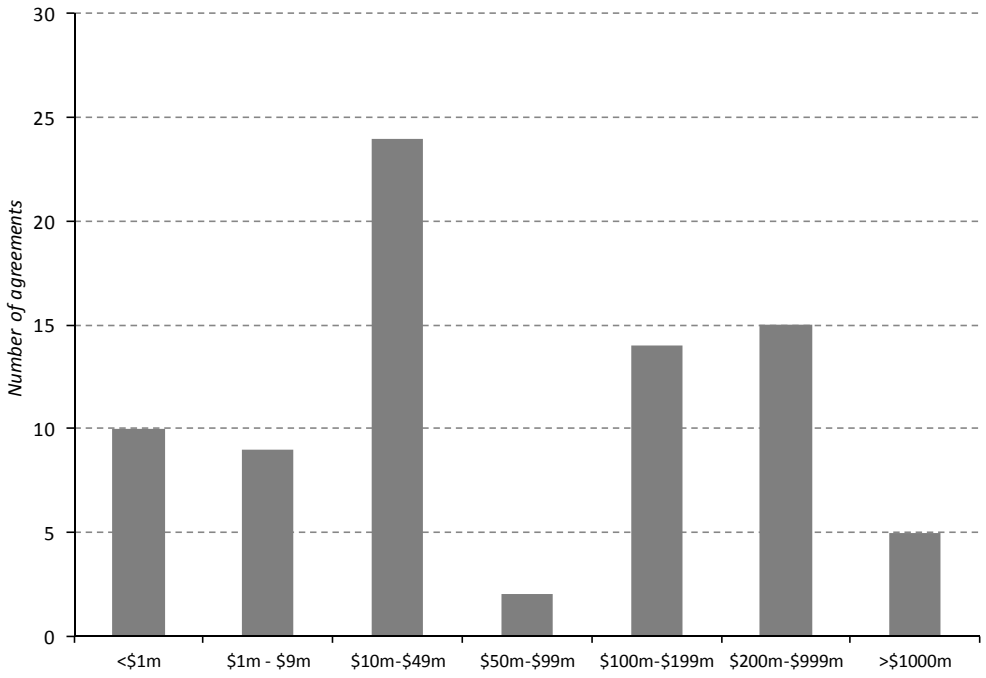
Nonetheless, just four years on, there are now more funding agreements than before reform began.

By 1 July 2012, there will be an estimated 155 active agreements, including NPs, Implementation Plans under omnibus NPs, Project Agreements and deemed agreements.

As Chart 8 illustrates, a significant proportion of these agreements involve less than $10 million in funding to Victoria. While these payments may be significant at the program level, and likely represent legitimate shared activities, it is doubtful that they warrant the same administrative and reporting framework as that which applies to projects and reforms of national interest. The proliferation of low value and often highly prescriptive NP payments distracts focus and resources away from those areas where national reform is critical.

[2] Council of Australian Governments meeting Communiqué – November 2008

**Chart 8: Agreements by funding amount to Victoria**




*Source: Department of Treasury and Finance, individual agreements*

## *Increasing red tape and bureaucracy*

The proliferation of agreements also imposes significant unproductive overheads at both negotiation and compliance stages.

The 2008 IGA sought to provide:

> Enhanced public accountability through simpler, standardised and more transparent performance reporting by all jurisdictions, with a focus on the achievement of outcomes, efficient service delivery and timely public reporting.[3]

Despite these intentions, the Commonwealth has sought to increase the reporting burden on states through NPs, for little or no public benefit. In many cases, the reporting burden associated with these agreements is unduly onerous relative to the low levels of funding available, and appears to be for the benefit of Commonwealth bureaucrats or Ministers rather than principles of public accountability.

An example of the excessive reporting burden is the OzFoodNet food safety agreement that delivers $880 136 to Victoria over four years, and requires the completion of 23 reports.

[3] *The Intergovernmental Agreement on Federal Financial Relations* 2008, Part 2, 5(b).

## 3. MAXIMISING THE STRENGTHS OF OUR FEDERATION

Australia has prospered as a federation, enjoying the strong economic and social outcomes federations have achieved compared to unitary nations. Federations perform strongly because decision making reflects local needs and priorities. This encourages innovation in jurisdictions that compete to provide the best policy solutions for their constituency. It is estimated that each Australian was $4 507 better off on average in 2006 as a consequence of federalism.[4]

The benefits of a federation lie in the differences between its jurisdictions. These differences create the opportunity for choice, competition, innovation and reform, driven by local circumstances and needs.

Competition across jurisdictions encourages states to innovate and act as test beds for reform which can then be refined and shared across borders. This process mitigates the risk of rolling out untested reform across the country, and works to identify best rather than average practice. For example, Victoria was the first state to implement an activity-based funding model for hospitals, now being rolled out across all states as part of national health reforms. Importantly, these reforms have been developed at the local level, in partnership with those delivering and using government services.

There is also a role in modern Australia for cooperative federalism – states working together and with the Commonwealth to deliver reforms of national significance.

### *Working with the Commonwealth and state governments to achieve reform*

Australia's federation is best served by an appropriate mix of competition and cooperation across governments. Reform must focus on ensuring best practice is pursued, not necessarily on achieving national uniformity.

Victoria supports the principle of harmonisation but only if the goal is to harmonise around best practice. Harmonisation based around the average, or worse, the lowest common denominator, risks reducing or stalling progress in public policy. For example, Victoria will not harmonise occupational health and safety (OHS) legislation according to the current model because many of the required changes would take Victoria backwards, imposing excessive and ultimately unjustified costs on Victorian businesses without a corresponding improvement in safety outcomes.

[4] Anne Twomey and Glenn Withers (2007), *Federalist Paper 1: Australia's Federal Future: Delivering Growth and Prosperity*, A Report for The Council for the Australian Federation

### *Harmonising OHS legislation: best, not average, practice*

Advice provided to the Victorian Government by PricewaterhouseCoopers estimates that the total cost to Victorian business of adopting twenty of the key national OHS laws would be approximately $3.44 billion over five years (net present value), including:

- transition costs of $812 million, as businesses understand the changes and modify their policies, practices and workplaces to comply with the new laws; and
- ongoing annual costs to businesses in Victoria in the order of $587 million over the first five years. [5]

These costs would be borne primarily by small enterprises (one to 19 employees), representing 90 per cent of Victorian businesses, which would incur 78 per cent of transition costs and 74 per cent of ongoing costs.

Victoria should only move away from its own system towards a national system when there are clear benefits from harmonisation. Of the 20 main changes between current Victorian law and the proposed model laws, PricewaterhouseCoopers assessed only three changes as likely to have a net positive impact on Victoria.

Victoria has a strong history of unilaterally initiating reform, developing models later applied in other states and nationally. For example, Victoria developed the core elements of vocational education and training reforms now being applied nationally. Indeed, history has shown that recent significant national reforms have typically started in one state and then have been shared across the country.

Reform does not always require the involvement of the Commonwealth Government or COAG.

The New South Wales and Victoria *Interstate Reform Partnership* is an example of jurisdictions working together in areas of common interest to deliver reform of national significance. Representing more than half the country's population, the two states are examining potential reforms in the areas of apprenticeships, energy efficiency schemes and ongoing sharing of best practice in a range of policy and service delivery areas.

The Victorian Government will continue to work cooperatively with other states and the Commonwealth in areas where the case for reform is built on strong evidence, where a national approach will produce best practice, and where there is a clear demonstrable benefit to Victorian business and households.

The proposed National Disability Insurance Scheme (NDIS) has the clear potential to be a beneficial national approach based on Commonwealth–state cooperation.

[5] PricewaterhouseCoopers 2012, *Impact of the proposed national Model Work Health and Safety Laws in Victoria – Summary Report of Supplementary Impact Assessment*, p.1.

### *The National Disability Insurance Scheme*

The Productivity Commission's Disability Care and Support Inquiry recommended a national scheme to provide insurance cover for all Australians in the event of significant disability – the NDIS. Its main function would be to fund long-term care and support for people with a disability. Consistent with the Productivity Commission findings, Victoria supports a national scheme. The Commonwealth has the revenue base to provide the additional funding required while the states, with the on-the-ground experience, would play a significant and ongoing role in its design and implementation.

Tax reform is another area where a national response is required. The *Australia's Future Tax System Review* acknowledged that a cooperative Commonwealth-state approach was needed to progress tax reform. The Victorian Government is willing to work collaboratively with the Commonwealth on significant national tax reform.

## *A modern and fair system of federal financial relations*

Competitive and collaborative federalism cannot function effectively without a significant degree of state policy autonomy. The system of federal financial relations must be designed to recognise the primary responsibility of states for provision of core services and infrastructure. It should do so through the efficient transfer of revenues, bridging the gap between state expenditure responsibilities and practical capacity to raise funds. This framework must enable the states to tailor services to local needs, encourage and reward innovation and hold governments accountable to their constituents for performance against agreed outcomes.

The Commonwealth now has the opportunity to work with the states to reposition federal financial relations for a modern Australian federation – recommitting all governments to the principles of efficient and flexible funding design, and replacing the outmoded model of HFE with one that reflects modern Australia.

The 2008 IGA (described in detail in Appendix B) provides a blueprint for more efficient, effective federal financial relations. It has already facilitated a wide range of useful reforms, and enhanced clarity of responsibilities for core services. With commitment by all governments to full implementation, this agreement can achieve its promised administrative efficiencies, and drive reform and enhanced outcomes.

Australia should also pursue a model of financial transfers that recognises the profound changes over past decades. The current model of HFE is unjustifiably complex, volatile and inefficient. The modern Australian federation needs a form of HFE that promotes efficiency, recognises the maturity of all states and is simple and transparent. It would allow states like Victoria to maximise their innovative and productive capacity in response to current economic transitions, and ensure that states undertaking difficult and necessary reforms gain the fruits of that reform.

The Victorian Government recognises that some states face challenges in raising their own revenue to deliver services. These entrenched policy challenges should be appropriately supported by the Commonwealth through targeted and tied payments.

Pursuing these actions will ensure Australia continues to enjoy the benefits of its federal system – not just the costs.

# APPENDIX A – AUSTRALIAN FEDERAL FINANCIAL RELATIONS

## Vertical fiscal imbalance

Australian federal financial relations are characterised by vertical fiscal imbalance (VFI). Although the states are constitutionally responsible for delivering most services, the Commonwealth raises most of the revenue. VFI between the Commonwealth and the states makes states heavily reliant on Commonwealth tied and untied transfers to deliver the services for which they are responsible.

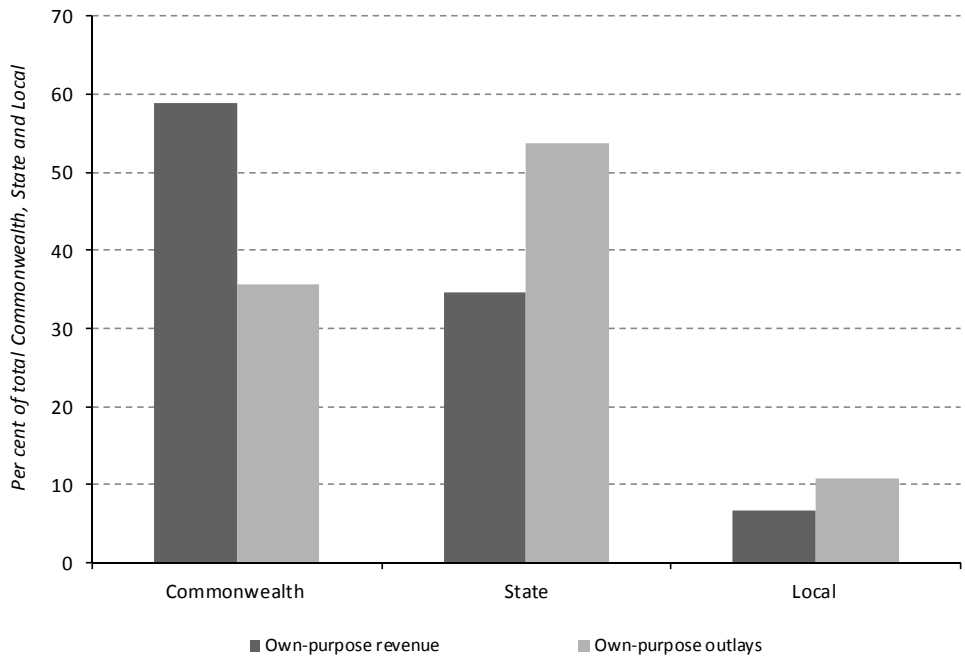
While some level of VFI is considered appropriate in a federation, an excessive degree is undesirable because it blurs roles, responsibilities and accountability between levels of government.

Specifically, it can:

- weaken accountability to the public by breaking the nexus between a government's decisions on the level of service provision and the revenue raised to fund it;
- reduce transparency regarding who is responsible for which government services, allowing governments to avoid responsibility by shifting blame for funding and operational shortfalls to other levels of government;
- create inefficiencies, through bureaucratic overlap, duplication and the cost of administering grants between governments;
- misallocate resources, through inadequate or inappropriate funding of services; and
- slow the responsiveness of government to the needs of communities.

Chart A1 illustrates the stark difference in Australian governments' respective shares of revenue-raising and service-delivery expenditure responsibilities.

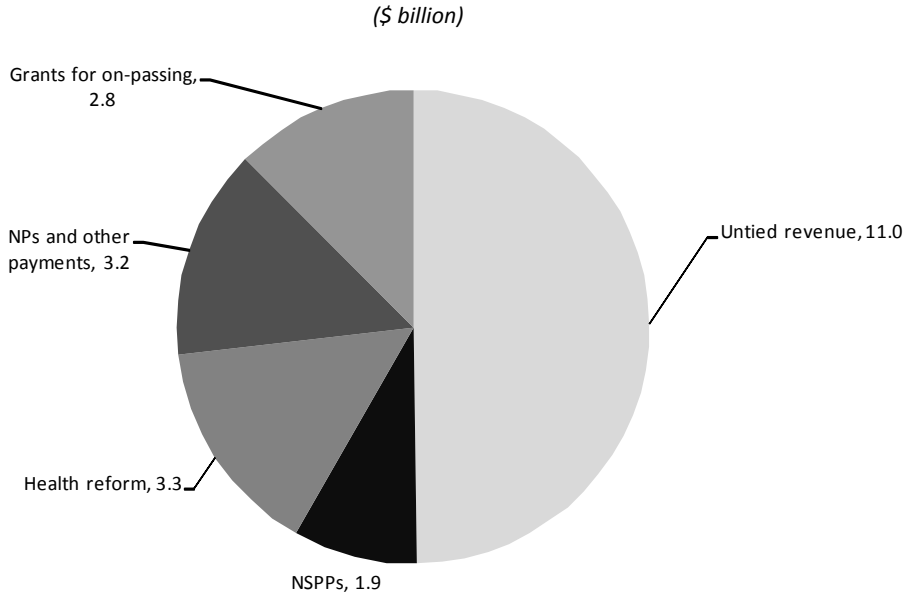
**Chart A1: Shares of national revenue raised and service delivery responsibilities, 2011-12**




*Source: ABS Cat. No. 5501.0.55.001 Government Financial Estimates, Australia, 2011-12*

In 2012-13, Commonwealth grants will provide around 46 per cent of Victorian Government revenue, including grants for on-passing. Around half of this funding is untied general revenue assistance, which comes primarily from Victoria's share of national goods and services tax (GST) revenue. The remainder is received in the form of tied grants, predominantly ongoing National Specific Purpose Payments (NSPPs), National Partnership (NP) payments and new national health reform funding.

**Chart A2: Commonwealth transfers to Victoria 2012-13**




*Source: Department of Treasury and Finance*

## *Commonwealth transfers to the states*

At federation, the newly formed Commonwealth absorbed only customs and excise duties from the former colonies. These duties comprised around a quarter to a half of colonial revenue, however much of this came from intercolonial duties that ceased to be levied upon federation.[6] In 1902, before becoming Prime Minister, Sir Alfred Deakin accurately predicted the following 110 years of federal financial relations in a letter to *The Age*.

> The rights of self-government of the States have been fondly supposed to be safeguarded by the Constitution. It left them legally free, but financially bound to the chariot wheels of the central government. Their need will be its opportunity. The less populous will first succumb, those smitten by drought or similar misfortune will follow, and finally even the greatest and most populous will, however reluctantly, be brought to heel.[7]

Since early in the federation, funding has been provided to less developed states. Increasing levels of revenue have been transferred to all states since the mid-twentieth century, including the most developed, in recognition of greater levels of VFI.

[6] John Wanna 2009, *Intentionally Bound to the Chariot-Wheels of Central Government – Federal Financial Relations revisited*, http://ppn2009.anu.edu.au/paperssafe/Wanna.pdf, p.4.

[7] Ibid.

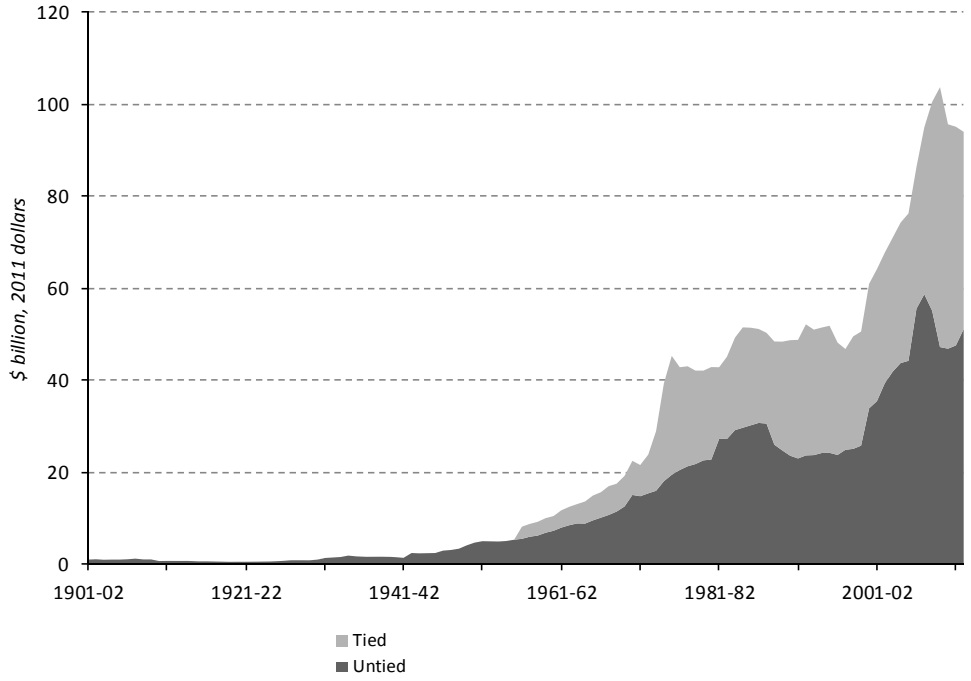
The transfer of Commonwealth funds to the states to compensate for VFI is provided through two broad funding types:

- untied funding, provided without any requirements on how it is spent; and
- tied funding, which has a level of prescription on how it can be used by a state.

Untied funding has been provided since early in the federation. Tied funding has become more prevalent since the 1950s with the advent of payments for specific purposes, and has increased markedly since the 1970s.

The quantum of funding has steadily increased in real terms, especially since World War II when the Commonwealth took effective control over income tax as an emergency measure. After the War, the Commonwealth declined to surrender its dominance of income tax. The introduction of the Commonwealth-levied GST in 2000, which replaced a number of state taxes, further exacerbated VFI. Chart A3 illustrates the growing level of transfers to states.

**Chart A3: Real annual Commonwealth funding to states and territories**




*Source: Department of Treasury and Finance*

## APPENDIX B – THE 2008 INTERGOVERNMENTAL AGREEMENT ON FEDERAL FINANCIAL RELATIONS

The introduction of the goods and services tax (GST) in 2000 was underpinned by the *1999 Intergovernmental Agreement on the Reform of Commonwealth-State Financial Relations* (1999 IGA). Under the 1999 IGA, states agreed to abolish a number of inefficient taxes. In return, the Commonwealth would provide the entirety of the GST to the states in untied form as a replacement for these taxes as well as the previous Commonwealth Financial Assistance Grants and revenue replacement payments. Victoria was the first state to abolish all the taxes agreed to under the 1999 IGA. Some states are still to fulfil their commitments.

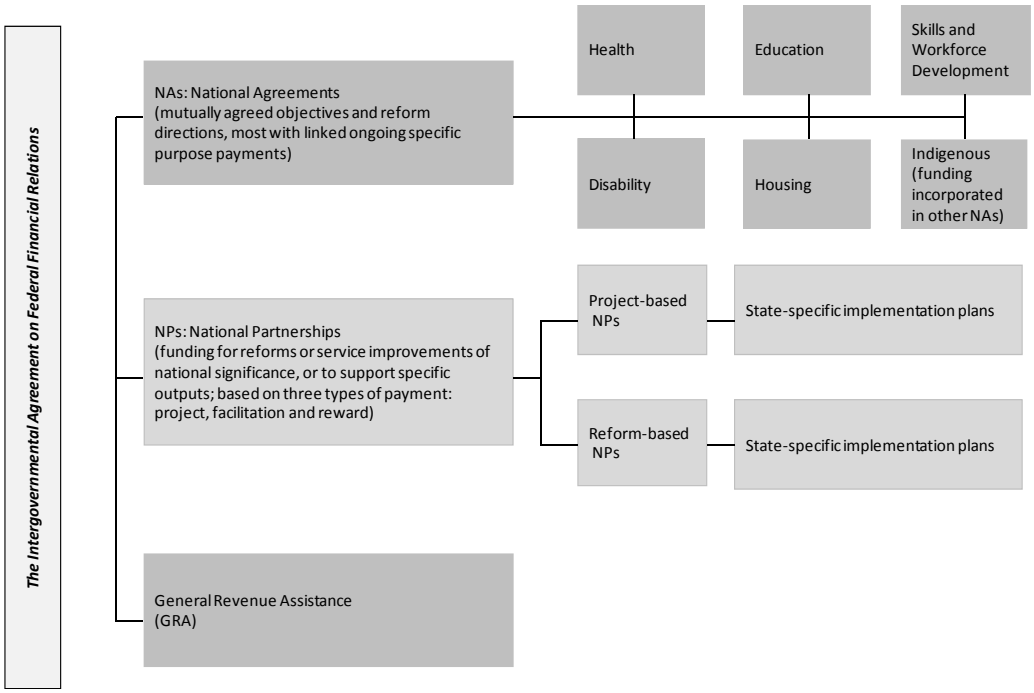
In 2008, governments worked together cooperatively to develop the *Intergovernmental Agreements on Federal Financial Relations* (2008 IGA). This agreement sought to simplify and clarify Commonwealth-state financial flows, and to recognise the importance of state flexibility in delivering services against local circumstances. This IGA also recommitted to the principle of the GST remaining as untied funding.

A number of specific purpose payments were amalgamated into five National Specific Purpose Payments (NSPPs), supporting overarching National Agreements (NAs), in the key service delivery areas. These NSPPs were outcomes-based, ongoing and indexed annually.

A second main type of funding mechanism, National Partnerships (NPs), was introduced to support specific projects or to test new service reforms. In both cases, funding was time-limited, but with a recognition that if reforms improved outcomes, serious consideration would be given to continuing funding and rolling it into the relevant NSPP. Again, the intent was to minimise the prescriptions on delivery methods (input controls) and to focus instead on outcomes.

The IGA established a new structure for Commonwealth payments, illustrated in Figure B1.

**Figure B1: Commonwealth transfers to states and territories as established under the 2008 IGA**




*Source: Department of Treasury and Finance*

*Note: Changes as a result of the 2011 National Health Reforms are not reflected in this diagram*

If you would like to receive this publication in an accessible format please telephone 9651 0909 or email information@dtf.vic.gov.au.

This document is also available in PDF at www.budget.vic.gov.au.

2012-13 Federal Financial Relations
Budget Information Paper No. 3
www.budget.vic.gov.au

Department of **Treasury and Finance**