



Australian Government
Productivity Commission

SHIFTING THE DIAL



5 YEAR PRODUCTIVITY REVIEW

SUPPORTING PAPER NO. 14

COMMONWEALTH-STATE
RELATIONS

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Publications enquiries

Media and Publications, phone: (03) 9653 2244 or email: maps@pc.gov.au

The Productivity Commission

The Productivity Commission is the Australian Government's independent research and advisory body on a range of economic, social and environmental issues affecting the welfare of Australians. Its role, expressed most simply, is to help governments make better policies, in the long-term interest of the Australian community.

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Further information on the Productivity Commission can be obtained from the Commission's website (www.pc.gov.au).

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Key points

- The scope of activities jointly covered by the Commonwealth and States is extensive, with expenditure on health, education and road transport alone accounting for nearly 40 per cent of government spending in 2015-16. Governments are also jointly involved in regulating or overseeing reform in many markets and policy areas, among them energy supply, water resource management, freight transport markets and national security.
- The quality of institutional processes and relationships between governments affect the quality of services and regulation produced by them. They are also key factors affecting governments' own productivity, an increasingly important factor in Australia's overall productivity performance.
- Intergovernmental relations in Australia reflect the dominant financial position of the Australian Government and its increasing involvement in areas that were traditionally the responsibility of the States and Territories. This is a result of the Commonwealth's relative revenue-raising strength resulting from historical events and High Court decisions, as well as social and economic changes that have resulted in a converging of local and national interests.
- The high level of States' financial reliance on the Commonwealth has long raised concerns about autonomy and accountability for decisions. In recent years, there has been an increase in the proportion of tied (conditional) payments to States, and funding considerations have come to dominate the dynamic of intergovernmental relations.
- All federal systems have some level of vertical fiscal imbalance (VFI), and completely eliminating it does not seem feasible. Improving the efficiency of tax bases at the State or Commonwealth level would increase the level of funding available to the States, or for distribution. However, this may not significantly relieve underlying pressures on revenue-sharing.
- A joint commitment to address revenue-sharing pressures is required if there is to be a reduction in the scope for inefficiency arising from imbalances in taxing power.
- Regardless of the level of VFI, the existence of large areas of shared responsibility and the likelihood that there will be new areas of shared interest in future require governments to agree to solve issues in the national interest. This can be aided, but not substituted by, institutional mechanisms to support government cooperation and accountability.

Commonwealth-State relations

1 Introduction

Australia's federal system of government has been in place since 1901. The formal rules of Australia's federal system are set out in the Australian Constitution. It assigns certain exclusive powers to the Commonwealth and specifies areas of shared responsibility by the Commonwealth and the States. Responsibility for all other matters is left to the States (box 1).

Box 1 The division of powers under the Australian Constitution

The division of powers under the Australian Constitution provides the Australian Government with:

- a small number of *exclusive* powers — mainly in respect of customs and excise duties, the coining of money and holding of referendums for constitutional change
- a large number of areas under section 51 where it can exercise powers *concurrently* with the States. However, to the extent that State laws are inconsistent with those of the Commonwealth in these areas, the laws of the Commonwealth prevail (section 109).

State Governments have responsibility for all other matters.

While the list of legislative powers for the Australian Government does not mention a number of specific functions (such as education, the environment and roads), this does not preclude action by the Australian Government in these areas. For example, while the Australian Government has no specific power in relation to the environment, it can legislate in this area under its external affairs power in support of any international agreement covering the environment. The government draws on its taxation powers and powers relating to interstate trade to intervene on roads.

Section 51 enables the states to voluntarily hand over responsibilities to the Commonwealth for certain areas. For example, in 1996 Victoria handed over arbitration power to the Commonwealth. It also enables the States to cooperatively enact identical legislation to the Commonwealth to set uniform standards (for example in regard to the offshore oil and gas industry and air safety regulations).

Sources: PC (2006); Constitutional Centre of Western Australia (2017).

The scope of activities jointly covered by the Commonwealth, States and Territories is extensive, with expenditure on joint health, education and road transport responsibilities alone accounting for nearly 40 per cent of all government spending in 2015-16. Governments are also jointly involved in regulating or overseeing reform in many markets and policy areas, among them energy supply, water resource management, freight transport markets, agricultural sectors such as fishing and national security.

The quality of institutional processes and relationships between governments affect the quality of services and regulation produced by them. They are also key factors affecting governments' own productivity, an increasingly important factor in Australia's overall productivity performance given the relative growth in services that are procured or delivered by governments (SP 2). Lifting prospects for future growth in national income and living standards will require concerted, and in many areas, joint, action by governments.

The Constitution does not set out any 'rules' to manage Commonwealth-State relations or institutional structures to facilitate these relations. As a result, arrangements for cooperation between the Commonwealth and the States have evolved over time to respond to the various economic and social challenges that have arisen.¹

Presently, there is markedly more harmony among first ministers (COAG) in dealing with social policy and national security issues than on economic reform issues (box 2). Confidence between governments on the latter seems low — reflected, for example, in the reaction to a new competition policy reform agenda at COAG in December 2016, and current disputes over energy supply. There has, however, also been less success in this forum for some time on market-based reforms.

Box 2 Tensions between governments are not new

In any federation there is always likely to be some tension between governments as the interests of sub-national and the national governments will not always converge. Tensions between the Commonwealth and the States and Territories are not new and have existed to a varying degree since federation. In some circumstances, tensions have been beneficial, leading to greater contest in policy ideas, for example in some areas of the provision of aged care services. The desire, therefore, is not necessarily that tensions be removed, but that governments be willing and commit to resolve issues in the national interest.

Some participants have suggested that intergovernmental processes have deteriorated to a point that Constitutional amendment should be considered. The evidence belies this, with cooperation evident on a range of issues, such as counter-terrorism, organised crime and domestic violence. The Commission also understands that Ministerial Councils on Health, Agriculture, Treasury and Transport work reasonably well, as do officials in preparation and follow up. In areas covered by this Report, consultation by the Commission across senior representatives of governments involved in both bilateral and full national exchanges indicate that there is a willingness to acknowledge the merits of other positions and work to effect change.

There are clearly fissures, however, and there has been limited coordinated effort on longer-term reform issues, especially market-based reforms, in recent years.

Source: PC (2006).

¹ Australian federation came about from process of deliberation, consultation and debate to address the increasing inefficiencies of having six separate colonies operating alongside each other, a recognition of the need for a national government to deal with issues such as trade, defence and immigration and a growing sense of Australian national identity (PEO 2017).

There will inevitably be instances of political difference. Of more concern in this Review is any persistent failure of governments to address looming risks to the wider public interest. Recent form suggests the need for serious renewal of commitment among governments to work cooperatively if prospects for growth in living standards are to be materially advanced.

At least two structural matters deserve closer attention in considering renewal: the underlying trends that have changed the nature of federal relations, which have implications for how governments allocate roles and responsibilities for solving problems; and the high level of reliance by States and Territories on Commonwealth funding, which creates a range of inefficiencies.

2 Structural drivers of federal arrangements

Increase in areas of common interest

The increase in the Commonwealth's policy reach into areas that have traditionally been the responsibility of the States is a product of several long-term phenomena:

- High Court decisions such as the Uniform Tax cases (1942, 1957), the Tasmanian Dam case (1983), the State tobacco tax case (1997) and the Pape case (2009), which have expanded the Commonwealth's powers, including to raise revenue (box 3)
- social and economic changes (for example, the freer movement of people, goods and ideas, globalisation, the influence of trade agreements on domestic policy), which have broken down or blurred traditional boundaries between jurisdictions and linked local and national interests (the construction of a major port and the efficient functioning of cities is now seen as a local, state and national issue; concerns about the impact of inefficient taxes on economic growth drove the replacement of a range of State taxes with the GST in 2000, further shifting revenue-raising power to the Commonwealth) (Wilkins 2007).

There is likely to be continuing evolution in the matters deemed to be of common interest across governments. There are also continuing changes in how public services are demanded and can be delivered. These imply that negotiation on the roles of different levels of government are highly likely to be a periodic feature of intergovernmental relations for the foreseeable future. But governments have not addressed this in any systematic way.

Added to this in recent times is the era of social media and immediate communications for all — creating a pressure for instantaneous decisions — which has left governments in an invidious position: try to meet people's expectations and do so in real time; or try to explain why this might be undeliverable and risk the judgment of failing to communicate or failing to appreciate the issue (or generally, both).

Box 3**Milestones in the shift towards the Commonwealth's dominant financial position**

The Constitution sets out transitional financial arrangements between the Commonwealth and the States. These provided that for at least the initial ten years of federation three-quarters of all customs and excise revenue raised by the Commonwealth would be returned to the States (section 87) and that after five years following the imposition of uniform customs and excise revenue, the Commonwealth would return all surplus revenue to the States (section 94). However, financial power soon began to shift to the Commonwealth:

- The Surplus Revenue Bill 1908 permitted the Commonwealth to pay all surplus revenue into trust accounts – initially to finance pensions. The Surplus Revenue Bill 1910 ended reimbursement of customs and excise revenue to the States and replaced this payment with a per capita grant of 25 shillings.
- During the First World War the Commonwealth began to levy income tax and estate duties.
- In 1923 the Commonwealth began the provision of specific purpose grants with road grants to the States.
- The Loan Council was established in 1927, which provided for the Commonwealth to raise all loans on behalf of the States.
- The Commonwealth Grants Commission was established in 1933 to allocate assistance to the States to provide greater equity in service provision.
- Uniform taxation was introduced in 1942 to enable the Commonwealth to take control of the income tax base, primarily to fund the war effort. The Commonwealth announced in 1946 that these arrangements would continue. Challenges to these arrangements by Western Australia, Victoria, South Australia and Queensland were dismissed by the High Court on the grounds that section 51 of the Constitution gave the Commonwealth power to make laws in regard to taxation.
- Specific purpose payments increased following the Second World War, and by the 1970s were used in a range of areas including health, education, transport and urban and regional development.
- In 1997, the High Court of Australia ruled that State and Territory business franchise fees on petrol, tobacco and alcohols that had been in place for nearly 20 years were Constitutionally invalid (under section 90 only the Commonwealth can levy an excise fee).
- Under the relevant intergovernmental agreement, revenue from the GST introduced in 2000 is collected by the Commonwealth and passed back to the States and Territories (on the basis of fiscal capacity relativities estimated by the Commonwealth Grants Commission).
- More recently, the Chaplains case (2012) clarified limits of Commonwealth policy reach, finding that, in most cases, the Commonwealth requires some form of legislative authority in order to expend public money.

Source: James (2000).

Over the past three decades, the model for achieving national reform has shifted from broadly cooperative, focussing on resolving select matters spurred by common concerns, such as dealing with the land rights implications of the High Court's decision in the *Mabo* case and improving productivity in the wake of the early 1990s recession, to one that is more ad hoc, with many more matters now subject to intergovernmental agreements.

The reliance on funding transfers from the Commonwealth to deliver State core services and to incentivise reform has come to dominate the dynamic of intergovernmental relations (below).

Commonwealth influence on policy through funding

The States have long had a high level of dependence on financial transfers (figure 1). In 2015-16, the States and Territories collectively raised 55 per cent of their total revenue. By jurisdiction, this ranged from just under 30 per cent for the Northern Territory to just over 70 per cent for Western Australia (PM&C 2015).

This misalignment between revenue and expenditure by the different tiers of government, or vertical fiscal imbalance, is not uncommon in most federal systems, but Australia has a relatively high level of VFI compared to most other federations (figure 2).

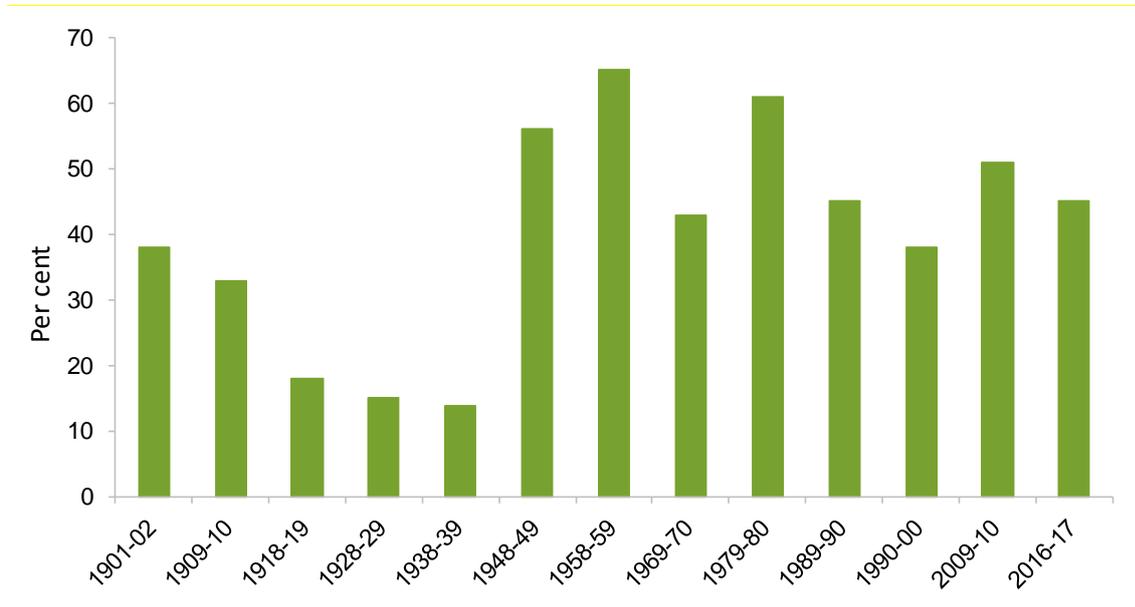
The potential tensions between governments associated with heavy reliance by the States on Commonwealth funding was recognised as early as 1902. In a letter to *The Age*, Future Prime Minister Alfred Deakin wrote: ‘The rights of the states have been fondly supposed to be safeguarded by the Constitution. It left them legally free, but financially bound to the chariot wheels of the central government’ (PM&C 2015).

The existence of VFI per se is not necessarily a problem, and it can provide certain benefits. For example, there are economies of scale in tax collection in having the central government collect the majority of tax, which reduces the administrative burden of tax collection. There can also be lower compliance costs for businesses that operate across jurisdictions in dealing with a single set of rules and a national tax collection agency.

VFI also provides the national government the capacity to equalise fiscal capacity between State governments to enable them to provide a similar level of services. It further provides the national government with the financial capacity to address issues that spill over jurisdictional lines, for example environmental issues that cross borders, such as those relating to water management in the Murray-Darling basin.

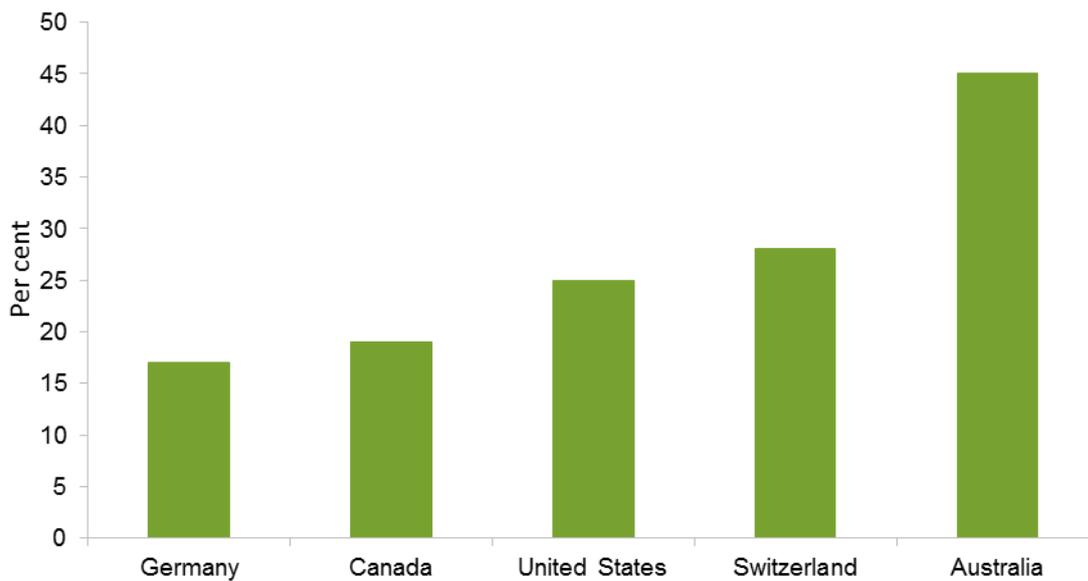
However, it has long been recognised that a high level of VFI can create a range of inefficiencies. The incentive for the States and Territories to become more efficient in the provision of services is muted when they do not have to tax their citizens for funding of relevant expenditure. At the same time, a heavy reliance on grants creates a lack of certainty in budgeting and planning as these grants can be unilaterally reduced to meet the changing priorities of the Commonwealth (PM&C 2015). The imposition of conditions on the use of funding may further limit States’ autonomy and blur accountability for outcomes.

Figure 1 VFI in Australia since federation
 (Commonwealth grants as a share of total State and Territory revenue)



Source: PM&C (2015).

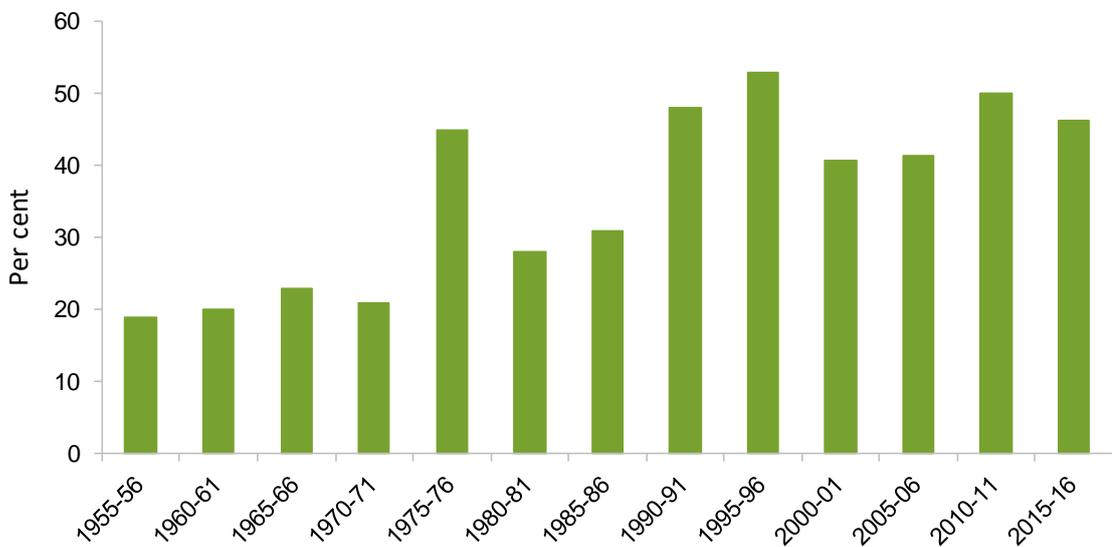
Figure 2 Vertical fiscal imbalance in selected federations
 (Defined as central government grants as a per cent of sub-national government revenue)



Source: PM&C (2015).

Of the funding provided to the States and Territories by the Commonwealth in 2015-16, 46 per cent was tied funding (specific purpose payments, including for health, education and housing). Specific purpose payments as a share of grants have grown since 2000, reflecting the Commonwealth's desire for assurance on the prudence and/or efficiency of spending and, with its increasing interest in policy areas, to incentivise reform through control of payments (figure 3).

Figure 3 **Specific purpose payments as a share of grants to the States and Territories**
1955-56 to 2015-16



Source: Commonwealth budget paper.

The remainder of grants (mostly provided from GST revenues) are untied, but subject to equalisation arrangements to address disparities in fiscal capacity between the States and Territories (horizontal fiscal equalization (HFE)).

The current HFE arrangements involve adjustments to the amount of GST revenue returned to each State and Territory. Although a system originally designed to affiliate the less populous states more closely to the federation, it is now a source of considerable tension at times within the federation (Pincus 2010). Common concerns have included that equalisation creates disincentives for recipient States and Territories to improve revenue raising capacity through tax reform and increase efficiency in service delivery and that HFE has created a 'grant dependency' in some jurisdictions. A separate Productivity Commission inquiry is presently examining HFE.

The Commission was told that funding is often the focus of and a major lubricant for intergovernmental cooperation. However, in recent times budgetary constraints have limited the ability of the Commonwealth to 'pay' for new reform on any significant scale.

The situation contrasts with the National Competition Policy program, where financial payments from the Commonwealth to the States were an ancillary, though important, reform tool whose rationale was based in the revenue that States might forgo for undertaking reforms.

The Commission was also told that some matters are being elevated to COAG not because of their policy importance but because they have funding implications, which under budget constraints require authorisation at first ministers' level (especially if trade-offs are required across portfolios).

Significant time and resources are devoted to negotiating and monitoring adherence to the terms and conditions of funding agreements. In health and aged care, the mix of funding and policy responsibilities among the various tiers of government has undermined the capacity for genuinely integrated care (chapter 2). More generally, concerns have been raised periodically about duplication or the need for better coordination of effort, uncertainties about whether value for money is being achieved, and accountability for outcomes.

Several have criticised the gatherings of First Ministers (the Council of Australian Governments (COAG)) as now being overly adversarial, too transactional, overburdened with agenda items and focused on arguments about funding.

3 What can be done?

Addressing the pressures of VFI

Improving the efficiency of tax bases at the State or Commonwealth level may increase the level of funding available to States, or for distribution, respectively. However, neither of these are likely to be sufficient in themselves to address the pressure of a high level of VFI.

The existing Constitutional arrangements and the High Court decisions since federation make it highly improbable that VFI could be eliminated completely and the States and Territories be in a position to raise all the revenue required to fund their own spending. One estimate is that the States and Territories would need to increase their own taxes and charges by about 90 per cent to displace all Commonwealth grants (Pincus 2010).² And simply increasing the 'pie' may not significantly reduce underlying pressures on how the pie is divided.

² This would vary considerably by jurisdiction. More contemporary estimates suggest that in 2015-16, Western Australia would have had to increase their own revenues by an estimated 60 per cent, New South Wales by about 90 per cent, Victoria by 110 per cent, Queensland 164 per cent, South Australia 200 per cent, Tasmania over 280 per cent and the Northern Territory by over 550 per cent to displace all Commonwealth grants (Commission estimates based on State and Territory budget papers).

A more fundamental change is required, therefore, having its objective the relief of pressure arising from revenue-sharing arrangements.

Past attempts to increase the fiscal autonomy of the States and Territories have failed, for practical and political reasons (box 4). A joint commitment to change is, nevertheless, required in order to reduce the scope for inefficiency and poor outcomes — including the stalling of other reforms requiring joint government effort — arising simply from imbalances in taxing power.

Box 4 Previous attempts to improve the States’ fiscal position

The Commonwealth made an offer to withdraw from the income tax arrangements in 1934. This was rejected by the States, and on this occasion Robert Garran stated:

We thank you for the offer of the cow,

But we can’t milk, and so we answer now –

We answer with a loud resounding chorus:

Please keep the cow and do the milking for us. (Garran 1958, quoted in (PM&C 2015) p, 9)

In 1970, the States proposed a scheme to allow the States to levy income tax, but this was rejected by the then Prime Minister as it would undermine the Commonwealth’s ability to influence macroeconomic policy. In 1978, the Commonwealth made an offer to the States to levy income tax surcharges or an income tax levy. This offer was declined, partly because the Commonwealth did not offer to lower its rates of income tax to ‘make room’ for the States to levy income tax. But in rejecting the Commonwealth’s proposal, the then Queensland Premier, Bjelke Petersen, also commented that, ‘the only good tax is a Commonwealth tax’ (Pincus 2010).

More recently, at the COAG meeting in April 2016 the Commonwealth indicated its intention to resolve the longstanding problem of VFI and improve state autonomy. The communique from the meeting noted that:

There was not a consensus among the states and territories (states) to support further consideration of the proposal to levy income tax on their own behalf. (COAG 2016, p. 2)

The communique further noted that leaders agreed to consider proposals to share personal income tax revenue with the States to provide them with a broader revenue base that grows in line with the economy, reduce the number of tied grants and provide the States and Territories with greater autonomy and flexibility to meet their ongoing expenditure needs (COAG 2016).

This Report proposes a joint commitment by governments *that does not necessarily seek to add to the tax burden* and, rather, relief from structures that are inimical in the longer term to efficient government. In this vein, there should also be less reliance on funding as a primary incentive for change, a mechanism that is also limited by its reliance on Commonwealth budget flexibility.

Division of roles and responsibilities

There are a number of well-established principles for the division of roles and responsibilities between governments, such as subsidiarity and fiscal equivalence. There is scope for differing views as to how to apply these principles in practice (box 5).

Box 5

Who should do what? — The principle of subsidiarity and fiscal equivalence

The principle of subsidiarity is often drawn on to provide guidance as to the appropriate level government for a particular function. Under this principle, responsibility for a particular function should, where practicable, reside with the *lowest* level of government. This is based on the following considerations:

- sub-national governments are likely to have greater knowledge about the needs of the citizens and businesses affected by their policies
- with decentralisation of responsibility and decisions it is easier to constrain the ability of elected representatives to pursue their own agendas to the disadvantage of citizens they represent
- intra-national mobility of individuals and businesses exposes sub-national governments to a reasonable degree of intergovernmental competition.

A key issue in applying the subsidiarity principle is to establish the meaning of ‘where practicable’. Although the public finance literature provides some guidance, there is considerable scope for differences of view in relation to the appropriate assignment of many expenditure, tax and regulatory functions (PC 2006).

There is also broad support for assigning responsibility to the *highest* level of government (the national government) where:

- there are significant interjurisdictional spillovers associated with the provision of goods or services at the sub-national level
- there are sizeable economies of scale and scope arising from central provision or organisation or readily identifiable areas of shared or common interest (for example, defence, international or external affairs and social welfare support)
- different rules or regulations are likely to give rise to high transaction costs with insufficient offsetting benefits (for example, regulation of companies, transport, the financial sector and trading provisions covering weights and measures)

Another consideration in assigning roles is fiscal equivalence. This requires that each level of government should be able to finance its assigned functions.

Sources: Productivity Commission (2006); Kasper (1995).

The assignment of functions is rarely ‘clean cut’ and most federal arrangements display varying degrees of exclusivity and overlap in the assignment of functions. Australia’s federal arrangements have displayed competitive federalism as well as collaborative approaches (box 6).

Box 6 Competition and cooperation in a federation

Competition between subnational governments is considered a strength of a federal system as it provides the incentive for governments to develop better policies and service delivery to meet the needs of mobile individuals and businesses. This horizontal competition is based on the discipline imposed on governments by the possibility of citizens and businesses ‘voting with their feet’ in response to policy differences. However, such competition is likely to be dampened where there is a lack of accountability and transparency as to which tier of government is responsible for providing particular services.

Competition may deliver perverse outcomes where it results in decisions leading to net costs to the State. In the past, concerns have been raised in this respect in relation to interstate ‘bidding wars’ to attract major projects and events and the use of special tax exemptions and concessions to attract businesses.

There is also vertical competition, where the national or subnational government governments enter a specific area in direct competition with the other level of government (for example, some State Governments introduced their own transitional programs to assist elderly people transition from hospital to the home) (PC 2005). Although, such competition can impose costs in terms of duplication and overlap, it can also potentially result in improved service delivery, or provide a means of testing a new model of service.

However, there are significant shared and overlapping responsibilities. The Constitution provides not only for exclusive powers assigned to the Commonwealth, but also a large number of areas under section 51 where the Commonwealth can exercise powers concurrently with the States. In light of this, governments in Australia have developed an extensive array of intergovernmental cooperative arrangements. These arrangements have largely recognised shared responsibilities and objectives and the need for effective cooperation and coordination to achieve policy outcomes.

The high point of such arrangements in Australia is often regarded as linked to the work of the Special Premiers’ Conferences and COAG during the 1990s in delivering the National Competition Policy reforms (PC 2006). This cooperation was underpinned by a desire to, in some cases, have a consistent national policy and supporting set of regulations and rules in some markets; in others, to reduce or remove rules that increased costs and restricted the movement of people and goods. More broadly, the NCP program sought to improve the efficiency of the economy by promoting competition in a range of industries. Payments by the Commonwealth to the States and Territories facilitated implementation of reforms.

Is there a 'best model' to assign responsibility?

In any federation there is no universally optimal model for assigning functions. Importantly, changing social, technological and economic conditions may make it necessary to review such roles and realign responsibilities from time to time. For example, policy issues such as climate change mitigation policy were not high on the agenda of governments 20 years ago. Other issues are also likely to emerge in the future making it impractical to determine 'who should do what' until such issues actually arise.

Existing policy issues are also likely to see shifts in responsibility. For example, the Commonwealth is now seeking to be involved with the States and Territories in improving the productivity of cities. And although the overall historical trend has been for increased Commonwealth involvement in many policy issues, some other areas are beginning to go against the trend. These tend to be in service areas, such as human services, where there are advantages from the local delivery of services and in having the providers of these services close to their clients.

The most recent attempt to substantially recast the relationship between the Commonwealth and the States was through the *Intergovernmental Agreement on Federal Financial Relations* (2008). National agreements made under the auspices of this overarching agreement define the objectives, outcomes and performance indicators of particular areas, and seek to clarify the roles and responsibilities of governments to guide them in delivering services in key sectors — including health, education, skills and workforce development, disability services, affordable housing and Indigenous reform (box 7). These arrangements have provided greater clarity on roles and responsibilities, but have not fundamentally altered intergovernmental dynamics.

In the spectrum of policy issues from the purely local, such as rubbish collection and the maintenance of street trees, to national issues, such as defence, there is a large area in the middle where although functions can be carefully negotiated, cooperation is likely to be necessary to ensure the effective delivery and efficient funding of services.

Box 7 Intergovernmental Agreement on Federal Financial Relations

The *Intergovernmental Agreement on Federal Financial Relations* was agreed to by the Commonwealth and the States and Territories in 2008 to consolidate and partially address the proliferation of small SPPs made by the Commonwealth to the States and Territories. It also sought to foster collaborative working arrangements, with more clearly defined roles and responsibilities.

Under the new arrangements, a wide range of specific Commonwealth-State agreements were subsumed into six National Agreements across the key areas of health care; education, skills and workforce development; disability services; affordable housing; and Indigenous reforms. Payments linked to these agreements are indexed annually and funding distributed to States and Territories by share of population.

In addition to the National Agreements, there are also the National Specific Purpose Payments (SPPs) in three service delivery sectors (skills and workforce development, disability and affordable housing).

The Agreement also provided for National Partnership payments to be made to the States and Territories to support specified outputs or project, facilitate reform or to reward those jurisdictions that delivered on nationally significant reforms or service delivery improvements. There are also Project Agreements that provide a simpler form of National Partnership for low value or low risk projects.

Until 2014, the COAG Reform Council (CRC) assessed whether the pre-determined milestones and benchmarks had been achieved before the Commonwealth made payment. Since the CRC was dismantled, the relevant Commonwealth Minister is now responsible for assessing the performance requirements to receive National Partnership payments.

Health and education account for about two-thirds of all funding for SPPs. National Partnership payments accounted for just over a quarter (26 per cent) of SPP funding.

Although there was some initial success in decreasing the number of funding agreements between the Commonwealth and the States, the number eventually increased. By 2010, the 6 National Agreements had been joined by 51 National Partnership Agreements and 230 Implementation Plans (National Commission of Audit 2014). As at 2016, there were 7 National Agreements, nearly 30 National Partnerships and nearly 50 project agreements (CFFR 2016).

The Agreement also sets out that the Commonwealth will make the payment of the GST revenues collected by the Commonwealth to the States and Territories in accordance with the principle of horizontal fiscal equalization.

Sources: COAG (2016); National Commission of Audit (2014).

CONCLUSION 14.1

VFI has been a feature of Australia's federal arrangements for some time. However, the reliance on funding transfers from the Commonwealth to the States to undertake core as well as reform activity has come to dominate the dynamics of the relationship.

Eliminating VFI does not seem feasible, although improving the efficiency of the national tax base, at both the Commonwealth and State levels, would potentially increase revenue available to the States, or for distribution.

Fundamentally, there is a need for relief from the revenue-sharing pressures created by the States' very high level of financial dependence on the Commonwealth.

Support for intergovernmental cooperation

The current peak intergovernmental body COAG, has existed since 1992. It meets on an 'as needed' basis and considers issues arising out of Ministerial Councils, the initiatives of the Commonwealth generally with respect to national reform, and issues requiring the cooperation of governments.

Although COAG played a key role in delivering major reform in the past, such as the NCP, there has been, as noted, some criticism of its current effectiveness.

In addition, the agenda of COAG is considered to be perennially overcrowded, raising concerns that COAG cannot deliver on its many commitments. This partly reflects the need to resolve portfolio-level issues that raise funding implications, as noted, leading to issues taking longer to resolve than necessary. But the Commission was told it also reflects an unwillingness of first ministers to delegate decision-making to their ministers.

In some cases, there may be scope for the States and Territories on their own to develop a solution to problems — for example, in the use of mutual recognition to address regulatory inconsistencies (PM&C 2015). Again, the issue of what COAG versus other ministerial forums should consider is not a new issue. Not long after the inception of COAG — in a review of Commonwealth-State reform processes for the Department of Prime Minister and Cabinet — it was noted that COAG's agenda needed to be focused on a few issues of significance that required the attention of heads of government. This would require officials to recommend what is suitable and what should take precedence (Weller 1995).

In regard to Commonwealth-State relations more broadly, the Commission was told that trust had been undermined where agreements between the Commonwealth and States — in particular as to the level and timing of funding to be provided to the States for infrastructure — had not been adhered to following a change of political leadership at the Commonwealth level.

The shared responsibility held by both the Commonwealth and States and Territories for many policy areas require effective arrangements to manage intergovernmental relations.

There are some lessons from history as to the drivers of effective intergovernmental cooperation (box 8).

Box 8 What has driven effective cooperation?

Effective cooperation between the Australian and States and Territories governments to a large part has been driven by common external causes and/or crises.

For example, the First and Second World Wars drove significant cooperation between the different tiers of government. More recently, the fear of economic stagnation that emerged in the 1970s along with reforms being undertaken by New Zealand in the 1980s provided the momentum for the Hilmer reforms of the 1990s. Other issues, such as Mabo, that rendered state borders irrelevant and required a policy response at a national level have also driven effective cooperation between the Australian and State and Territory governments.

Many inquiry participants commented that the commitment of individuals at both ministerial and bureaucratic level was crucial to the implementation and success of reform efforts.

Even after COAG had only been in place for a few years, in explaining the behaviour that had made progress possible, a review of Commonwealth-State reform processes found that, '... it is apparent that where the approach has been negotiable, cooperative and reiterative COAG has worked best' (Weller 1995, p. 13).

Effective cooperation and collaboration is also required in the implementation of agreed policy. For example, in regard to Australian and State and Territory Governments cooperation in health policy, previous experience highlights that for cooperation to be effective there needs to be a recognition of 'who is responsible for what' to ensure the necessary structural, legislative and regulatory changes can be implemented (Australian Centre for Health Research and TPG International 2010).

Changes to institutional arrangements have also arisen out of cooperative efforts to solve policy problems. COAG itself came into existence in the 1990s during a period of heightened cooperation between governments. The transition from Premier's conferences to the establishment of COAG and its related councils and the subsequent range of intergovernmental agreements delivered highlights this cooperation. Not all cooperation takes place within the formal COAG council system as portfolio ministers also meet to discuss and progress matters of shared interest. Without first ministers present and being out of the political spotlight, these meetings and forums often provide the opportunity for ministers in similar portfolios to focus on policy outcomes.

Stakeholder suggestions to improve the functioning of COAG meetings include:

- giving State and Territory Governments greater influence in the operations of COAG. It has been suggested that this be through an intergovernmental agreement recognising COAG as a partnership between governments. Practically, States and Territories would be more involved in setting meeting dates and the agenda, rather than relying on the Prime Minister and the Commonwealth to drive it. It has also been suggested that administrative support for COAG be at arm's length from the Australian Government
- to improve accountability and transparency, COAG and the Ministerial Councils should make public their agendas, work programs and intended outcomes, as well as achievements against those intended outcomes on an annual basis (BCA 2006).

There has been some experimentation with the bodies supporting COAG. The main Secretariat resides with, and is funded by, the Australian Government in the Prime Minister's Department. The secretariats supporting the ministerial councils usually reside in, and are funded through, the relevant Australian Government portfolio. An independent body, the COAG Reform Council (CRC), was established in 2006 to assist COAG to drive national reforms by improving accountability on the performance of governments. The CRC was abolished in 2014.

Between 2008 and 2014, the CRC reported annually on the outcomes agreed to through COAG. This involved benchmarking the performance of governments against outcomes specified under the National Agreements.

Since then, there has been a range of interim reporting arrangements led by the Department of Prime Minister and Cabinet with assistance from other agencies (COAG 2016). The payments made under the National Partnerships to the States and Territories for meeting agreed objectives are now assessed by the relevant Australian Government portfolio minister. The Australian Government recently restored independent monitoring and reporting on performance against COAG agreements by transferring this function to the Productivity Commission (2017-18 Budget).

In addition to the changes to the operation of COAG meetings suggested by stakeholders, there are also the guiding principles for cooperation as communicated by the Premiers and Chief Ministers in 1991 that still provide a sound framework for cooperation by governments (box 9).

While institutional supports are necessary and can facilitate the efficient conduct of meetings, such supports clearly cannot substitute for a willingness among first ministers to cooperate in the national interest.

Box 9 Federation principles — Premiers and Chief Ministers' conference Adelaide 1991

- **Australian nation principle:** all governments in Australia recognise the social, political and economic imperatives of nationhood and will work cooperatively to ensure that national issues are resolved in the interests of Australia as a whole.
- **Subsidiarity principle:** responsibilities for regulation and for allocation of public goods and services should be devolved to the maximum extent possible consistent with the national interest, so that government is accessible and accountable to those affected by its decisions.
- **Structural efficiency principle:** increased competitiveness and flexibility of the Australian economy require structural reform in the public sector to complement private sector reform: inefficient Commonwealth-State division of functions can no longer be tolerated.
- **Accountability principle:** the structure of intergovernmental arrangements should promote democratic accountability and the transparency of government to the electorate.

CONCLUSION 14.2

Australia's Constitutional arrangements and the shared responsibility held by both the Commonwealth and States and Territories for many policy areas call for effective intergovernmental cooperation.

The level of cooperation between the Commonwealth and the States has varied markedly over the past 20 years, and while there has been an absence of cooperation on several major policy issues, circumstances have not deteriorated to a level where the 'system is broken'.

The operation of COAG meetings could improve. However, institutional supports for COAG can have little impact without the political will to cooperate in the national interest.

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