



Queensland Treasury Response to Staff Discussion Paper CGC 2009/01-S

Treatment of Commonwealth Payments to the States

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SUMMARY OF QUEENSLAND'S POSITION

The Council of Australian Governments (COAG) agreed to a new model of co-operative Commonwealth-State financial arrangements which is outlined in the Intergovernmental Agreement on Federal Financial Relations (IGA). The agreement identifies the establishment of, and treatment by the Commission, of five new specific purpose payments (SPPs) and new National Partnership Payments to support the delivery of specified projects, and to facilitate or reward nationally significant reforms.

Importantly, the treatment of Commonwealth payments agreed by COAG are to ensure that any benefit to a State from achieving specified outputs sought by the Commonwealth, or through implementing reforms, will not be redistributed to other States through the Commission's horizontal fiscal equalisation (HFE) process.

COAG (via HoTs Deputies) considered options for reducing State budget shocks resulting from the change in Federal financial relations. COAG agreed through the IGA to phase-in new financial arrangements over a five-year period.

The IGA provides the Commission with a degree of flexibility when considering National Partnership payments. However, Queensland considers the Commission's methodology should reflect the overall objectives of the IGA and COAG's genuine intent of a new era in co-operative Commonwealth-State federal financial relations that in part, is based on a mutual expectation that National Partnership facilitation and incentive payments will be excluded from the Commission's methodology, and that the changes to Commonwealth payments will be phased in to reduce adverse impacts on state budgets.

Ideally, the Commission would be provided clear direction through its Terms of Reference for the 2010 Review. Queensland will seek the support of Heads of Treasuries (HoTs) to include COAG's agreed Commission treatments for Commonwealth payments in an updated Terms of Reference. However, even in the absence of such specific direction, Queensland urges the Commission to implement COAG intent in its treatment of Commonwealth payments.

The Commission Staff recommended that Commonwealth third-party payments be treated 'out of scope'¹, but also proposed that some third-party payments may indirectly affect States' fiscal capacities and therefore, should be recognised.²

Before any indirect impact on State fiscal capacities from Commonwealth third-party payments can be included in an assessment, the effect should be proven and quantifiable. Measurement of the indirect effect which will allow the more accurate application of disability factors when determining States' assessed expenses.

Queensland seeks clarification of the Commission's proposed treatment of Commonwealth payments under the Commonwealth's Nation Building and Jobs Plan.

¹ Staff Discussion Paper CGC 2009/1-S *Treatment of Commonwealth Payments to the States* para 15

² *ibid* para 25

Key Issues

- Queensland will seek, through HoTs, to have the Commission's Terms of Reference provide clear direction on the treatment of Commonwealth payments. However, in the absence of such direction, the Commission's treatment of Commonwealth payments should reflect the overall objectives of the IGA as agreed by COAG.
- Given COAG's phase-in arrangements, the proposal to backcast is not necessary, and if applied may in fact produce an outcome that is contrary to COAG's intent.
- More information on backcasting, including which major changes staff propose to include and proposed methodology, will be required for states to provide meaningful comments.
- Further information on the framework intended to be used to determine an indirect impact on State fiscal capacities from Commonwealth third-party payments is required to enable states to provide meaningful comments.
- Queensland considers Commonwealth payments received under the Nation Building and Jobs Plan should be excluded from the Commission's assessments.

ISSUES

Intergovernmental Agreement

On 26 March 2008, COAG agreed to a new model of co-operative Commonwealth-State financial arrangements which is outlined in the Intergovernmental Agreement on Federal Financial Relations (IGA).

In the IGA, COAG has detailed its required treatments of various Commonwealth payments by the Commonwealth Grants Commission (the Commission), namely:

- National SPPs – Inclusion
- National Partnership project payment – Inclusion
- Nation Partnership facilitation payment – Exclusion
- National Partnership incentive payment – Exclusion
- General Revenue Assistance – Inclusion

Importantly, the treatment of Commonwealth payments agreed by COAG are to ensure that any benefit to a State from achieving specified outputs sought by the Commonwealth, or through implementing reforms, will not be redistributed to other States through the Commission's horizontal fiscal equalisation (HFE) process.

The Commission's treatment of Commonwealth payments should be in line with the objectives of the IGA and COAG's determination that Federal financial relations are underpinned by a shared commitment to genuine cooperative working arrangements. Queensland sees the Commission's support of COAG's decisions as central to the IGA's success.

Facilitation and Incentive Payments

In paragraph D.41 of the IGA, COAG agreed that National Project payments would be treated “by inclusion” but that National Partnership facilitation and incentive payments will be treated “by exclusion”. Queensland considers both the Commonwealth and State Governments are providing clear direction to the Commission regarding the treatment of these Commonwealth payments. Most importantly, these agreed treatments of Commonwealth payments ensure that any benefit to a State from achieving specified outputs sought by the Commonwealth, or through implementing reforms, will not be redistributed to other States through the Commission’s HFE processes.

Queensland notes the Commission does have a degree of flexibility under paragraph D.42. (a) of the IGA to treat any National Partnership payment differently but only following genuine consultation with the Commonwealth and the States. However, Queensland does not agree that the Commission has the right to override specific directions in the IGA and in particular the directions in paragraph D.41.

The Commission has already set a precedent regarding the treatment of facilitation and incentive type payments to the States. It is proposed that the treatment of National Partnership facilitation and incentive payments be consistent with the treatment of the original reform payments, the former National Competition Payments, which were quarantined from the Commission’s assessment methods.

The Commission’s methodology should reflect the overall objectives of the IGA, in particular COAG’s genuine intention of co-operative Commonwealth-State federal financial relations and in part this is based on a mutual expectation that National Partnership facilitation and incentive payments will be excluded from the Commission’s methodology.

Queensland will seek the support of HoTs to incorporate COAG’s directions for the treatment of Commonwealth payments to the States in a revised Terms of Reference. However, in the absence of such direction, The Commission’s treatment of Commonwealth payments should reflect the overall objectives of the IGA as agreed by COAG.

Backcasting

COAG recognised that the move to distributing new SPPs by population share (or FTE student enrolments in government schools for the National Schools SPP) could result in a shift in payment shares. During the negotiation of the IGA, COAG (via HoTs Deputies) considered a variety of options for reducing State budget shocks resulting from the change in Federal financial relations, including backcasting and phase-in arrangements. The IGA (paragraphs D.58. to D. 61.) details COAG’s agreed phase-in arrangements.

Queensland believes the Commission Staff proposal to backcast the changes in Federal financial arrangements into the assessment years is premature and requires further consideration.

Commission Staff should consider:

- COAG's decision to phase-in of the new Federal financial arrangements. There is a risk that backcasting by the Commission will result in greater complexity, and amplification of the fiscal impacts COAG is seeking to reduce; and
- COAG's phase-in arrangements avoid the need to backcast by allowing the Commission to include actual payments in the year they are made.

For States to provide additional and productive feedback, Commission Staff should clarify which changes it proposes to backcast, identify its proposed method of backcasting these major changes and analysis of the impact on revenue distribution.

Out of Scope/Indirect Payments and Substitutes

The Commission Staff are recommending that payments by the Commonwealth to non-general government agencies (i.e. public trading enterprises), non-government organisations (NGOs) and to individuals be considered 'out of scope'. However, Commission Staff also propose that some of these payments may indirectly affect States' fiscal capacities and should be recognised. The Commission Staff proposal is based on an assumption that even though these payments are considered out-of-scope they may indirectly reduce State assessed expenses.

To ensure that disabilities are measured and included appropriately in the affected expenditure categories, Queensland considers that before any indirect impact on State fiscal capacities from Commonwealth third-party payments can be included in an assessment, the impact should be proven and quantifiable.

This raises several questions regarding how the Commission Staff could assess or measure any indirect impact on States services funded by these third party payments, including:

- Are the third-party services and State provided services 'perfect substitutes'?
- Would States provide program funding if the third-party payments ceased?
- What Commonwealth payments to third-parties indirectly reduce State assessed expenses and what third-party payments don't?

Queensland argued in its submission to Commission Position Paper CGC 2008/20 Community and Other Health Services that a case of 'perfect substitutes' did not exist and that substitution may result in material disabilities being underestimated.

The Commission contends that out-of-hospital services provided by the non-State Government sector³ augment State Government provided services. Queensland maintains this is not the case, medical services (including general practitioner) and pharmaceuticals are a large, core part of the health sector and are key drivers in the health sector in their own right.

³ Professor James RG Butler, *A review of the proposed approach to the assessment of Community and Other Health services (A report prepared for the Commonwealth Grants Commission)*, Australian Centre for Economic Research on Health Page 6 Section 2.4 refers to health services provided by the Commonwealth and the States interchangeably as the "public sector".

State provision of community and other health services (COHS) are complementary to services funded through Medicare, but have distinct cost drivers. These distinct cost drivers present material disabilities which have not been captured in the assessment of States' total COHS.

In the expenditure categories affected indirectly by Commonwealth third-party payments, the Commission appears to accept that the services are 'perfect substitutes'. By accepting the 'perfect substitute' argument, the Commission makes an assumption regarding potential State expenditures in the affected expenditure categories. The assumption is that the Commonwealth payment reduces demand for the State service, reducing State expenditure in that expenditure category. Therefore, if the services are 'perfect substitutes' the opposite must also be valid. For example, if a Commonwealth third-party payment ceased then a State would step-in, fund and replace the service.

In reality, there is no guarantee that any State would allocate budget funds to replace services funded by Commonwealth third-party payments. Even if a State did so, it may decide to replace only a portion of the former Commonwealth payment – an 'imperfect substitute' at best.

Before the Commission accepts a Commonwealth third-party payment indirectly reduces a State expense it should test:

1. whether the services funded are in fact 'substitutes' and/or
2. the degree of substitutability.

For the Commission Staff's 'substitutes' argument to be valid, for each affected expenditure category there should be a measure of substitutability between the Commonwealth service, the associated State service and their respective cost. This measure could then be used to more accurately gauge the indirect impact on State assessed expenses, allowing the more accurate application of disability factors. Queensland believes that if judgement is applied in any resulting disability factor, the rationale for that judgement must be transparent.

A determination on this matter is essential as the Commonwealth moves to shift the financial responsibility for some services such as public housing⁴ away from the State Government sector to the not-for-profit sector (NFPS) under the Nation Building and Jobs Plan. The Commonwealth has indicated that it expects much of the Nation Building and Jobs Plan funding to go to Non-Government Organisations (NGOs). For States with few NGOs in remote locations, such as Queensland, Western Australia and the Northern Territory, the funding may be through the state government. It would not be appropriate for these states to be penalised simply for not having NGOs to deliver the Commonwealth program.

The Commonwealth has announced that it will spend \$6.5 billion of its Stimulus Package on public housing and hand over property deeds to the community housing sector by 2012. With the Commonwealth funding the majority public housing (new SPP and to the NFPS) and providing rental assistance, housing services provided by the States can only complement those provided by the Commonwealth.

⁴ ABC News, 'Not-for profit sector to control public housing'
www.abc.net.au/news/stories/2009/03/20/2521292.htm?section=justin

The Commission should identify which Commonwealth third-party payments it considers indirectly reduce State assessed expenses. Therefore in the interests of transparency and further analysis, consideration should be given to extending Table A in Staff Discussion Paper CGC 2009/01-S to include the indicative treatment of Commonwealth third-party payments relating to ‘substitutable’ services.

Nation Building and Jobs Plan

Funding under the Nation Building and Jobs Plan is a competitive process with States bidding for project funding. States may be less inclined to bid for funds under the Nation Building and Jobs Plan as they become aware that potential funding could be equalised away through the Commission process. This will defeat the objective of this Commonwealth Government’s initiative. It is Queensland’s view that the Nation Building and Jobs Plan should be excluded from the Commission process.

If included, payments made under the Nation Building and Jobs Plan have the potential to distort a variety of assessments with resultant ‘lumpy’ variations to revenue distribution. These payments should not be backcast as a major change in Federal financial relations. Further, any indirect payments made to third-party service providers should not be assessed as indirectly affecting a State’s fiscal capacity.