

Reform of the Federation

Discussion Paper
2015

CONTENTS

Chapter 1: The challenges facing Australia's Federation

Chapter 2: Improving Australia's Federation—how to design the new arrangements

Chapter 3: Governance and accountability

Chapter 4: Key areas for reform

4.1 Health

4.2 Education

4.3 Housing and homelessness

Chapter 5: Federal financial relations

Appendices

Appendix 1: Terms of Reference for the Reform of the Federation White Paper

Appendix 2: Summary of stakeholder consultation roundtables

Appendix 3: Prime Minister's Expert Advisory Panel

CHAPTER 1: THE CHALLENGES FACING AUSTRALIA'S FEDERATION

1.1 Context

Australia's Federation has worked well since 1901.

Since that time, Australian governments have worked together to help deliver a standard of living that makes us the envy of much of the world.

Australia today, though, is very different from the country it was back then—the world in which Australians live has changed enormously, and continues to change at a rapid rate.

So, the question needs to be asked—is our Federation still fit for purpose?

Does it provide the system of national governance that Australians need right now, and will it help or hinder efforts to adapt and thrive in the vastly different economic, political and social realities of the 21st century?

There are many opportunities and challenges facing the Australian economy. Asia's economic strength continues to increase and the global economy is becoming more integrated.

There is no room for complacency, otherwise Australia risks being left behind on the world stage—meaning fewer jobs, lower economic growth, and lower living standards.

This challenge should not be underestimated.

Technological change is disrupting and making obsolete traditional models of business and government. It is also empowering individuals and local communities with new knowledge and opportunities.

Is Australia ready for this?

Australia still has a relatively small population dispersed over a large land mass, but the make-up of our population is now very different than it was 1901. Australians are now more ethnically, geographically and economically diverse, older, and more connected to one another and to the world as a result of technological change.

While many Australians now live longer than most other people—mostly as a result of advances in treating many illnesses¹—our advances in health and life expectancy are not evenly shared across the population, in particular amongst Indigenous Australians, people from low socio-economic backgrounds and those living in regional and rural areas.

All of this brings extra demands and costs for the services expected from governments.

¹ Australian Institute of Health and Welfare, *Australia's Health 2014: in brief*, Canberra, 2014, p.2

The number of Australians aged 65 and over is expected to double by 2054-55.² This will place pressure on all governments' budgets, as older Australians tend to be higher users of government services.³ Governments also face pressure to better target and coordinate services to vulnerable Australians to ensure they are not left behind.

Changes to the way Australians choose to live are also increasing government expenditure. For example, advances in technology and higher incomes (leading to individuals purchasing more services) are driving up government expenditure, especially on social services.⁴ The Grattan Institute has estimated that, if the scope of health services continues to increase at recent rates, total government health expenditure will increase by as much as 2 per cent of GDP by 2023.⁵

All governments are facing budget pressures and not just in health.

After a quarter of a century of unprecedented economic growth, both the Commonwealth and the States and Territories are facing downward pressure on their revenues, largely as a result of the fall in commodity prices.⁶

Not only do the public's expectations of high quality public services continue, but perhaps now more than ever, Australia needs a well-educated and highly skilled population to continue to compete on the global stage and maintain the high standard of living to which Australians have become accustomed.

The way governments work together to deliver public services—like health and education—needs to be as efficient as they can be, to secure Australia's future as a high wage and internationally competitive economy.

The impact this has on businesses and service providers also needs to be assessed, so they can be freed up to do what they do best—innovate and create opportunities—rather than spending their time dealing with multiple layers of government.

Most Australians believe that, while the Federation is mostly working well, it is not working as well as it could, and this is contributing to a lack of confidence and trust in our system of government to deliver better services.⁷

In any Federation there is a degree of overlap and duplication in the roles and responsibilities of the different levels of government.

² Commonwealth of Australia, '2015 Intergenerational Report, Australia in 2055', Canberra, 2015, p. 1

³ Commonwealth of Australia, 2015 Intergenerational Report, Australia in 2055, p. 58

⁴ Commonwealth of Australia, 2015 Intergenerational Report, Australia in 2055, p. 61

⁵ J Daley, C McGannon, and A Hunter, *Budget pressures on Australian Governments: 2014 edition*, Grattan Institute, Melbourne, 2014, p.20

⁶ Parliamentary Budget Office, *National fiscal trends*, Report no. 01/2015, Parliamentary Budget Office, Canberra, 2015, p. vii

⁷ A Brown, *Australian Constitutional Values Survey 2014*, Results Release 1, Griffith University, Brisbane, 2014, p.3, <http://www.griffith.edu.au/data/assets/pdf_file/0015/653100/Constitutional-Values-Survey-Oct-2014Results-2.pdf> accessed May 2015

Australia is no different.

On the one hand, this can be a positive—having more than one government involved can provide checks on the power of any one level of government. On the other, it can result in inefficiency caused by similar or conflicting policies, making it hard for end-users to navigate their way through the multiple policies or public programmes on offer.

The level of overlap and duplication in our Federation is becoming excessive, leading to wasteful expenditure, a constant ‘blame game’ between governments driving up the cost of public services, and people not really knowing which level of government is responsible for what.

At Federation, the Constitution limited the Commonwealth’s powers to a range of specific issues, leaving responsibility for a wide range of issues to the States.⁸ For example, the States and Territories are traditionally responsible for education, but the Commonwealth is heavily involved in the sector today.

The Commonwealth’s range of roles is now far wider than it was at the time of Federation, including in Indigenous affairs,⁹ and all levels of government are now expected to do much more.

While the Commonwealth’s involvement in a wider range of areas than what was envisaged in 1901 has undoubtedly led to significant and positive developments for the nation—for example the introduction of a national social security system and Medicare—the degree of interference in traditional areas of State and Territory responsibility has now arguably gone too far.

It is now the case that, in some areas, the States and Territories are no longer sovereign in their own sphere.

The Commonwealth and the States and Territories can, and do, work well together in many areas. There is, however, concern that the current balance within the Federation—with the Commonwealth involved in seemingly every policy area—is out of kilter.

Reform of the Federation, therefore, will need to improve the way the Commonwealth and the States and Territories work together, so the ways they exercise their roles and responsibilities are not at cross-purposes, and ultimately deliver better services for all Australians.

Roles and responsibilities

Before looking at the roles and responsibilities that underpin the Federation, it is important to explain what is meant by each term and how they are distinguished from one another.

Responsibilities are when governments are required to act in a certain area—including for example defence, public transport, or education. Responsibility may be held by one level of government, as

⁸ The Northern Territory and the Australian Capital Territory were conferred with self-government in 1978 and 1988 respectively.

⁹ The practical effect of the 1967 Referendum was to give the Commonwealth the power to create laws in respect of Indigenous Australians.

occurs with the Commonwealth being responsible for defence, and the States and Territories being responsible for urban public transport. Alternatively, responsibility can be shared between levels of government, as in education.

Responsibility is shared when more than one level of government is involved in the *roles* entailed in the exercise of responsibility. Roles are the functions governments undertake in carrying out their responsibilities. We have identified four broad types of roles within the current arrangements—where a government or governments can act as a:

- funder—by providing funding from its budget to pay for services (often this function is combined with the role of purchasing services from either government, non-government, or private service providers, but the purchasing or commissioning does not always have to be done by the level of government that is the funding source);
- high-level policy setter—by designing institutions or systems, and/or setting or determining overarching strategies, goals or minimum standards (including designing the framework or incentive structure under which services are provided, monitoring performance against those standards through collecting data and public reporting);
- service deliverer—operational responsibility for the delivery of services including determining how, by who and in what way services will be provided, noting that many services are delivered by the non-government sector; and
- regulator—by setting the ‘rules of the game’ and then monitoring and enforcing them (noting that rule-setting and rule enforcement do not have to be done by governments at all, or the same level of government).

1.2 The case for change: the challenges facing our Federation

What’s the problem we are trying to solve?

In embarking on any reform agenda, the first question that needs to be asked is—what is the problem we are trying to solve?

According to the Australian Constitutional Values Survey, over 80 per cent of Australians thought the performance of the Federation could be improved.¹⁰

Clearly, in the public’s mind there is a problem.

What is not as clear is whether that problem is with the model of federalism, a perception of being ‘over governed’, or something more concrete.

¹⁰ Brown, *Australian Constitutional Values Survey 2014*, p. 5

The stakeholder roundtable consultation process (undertaken during February and March 2015 to inform this Green Paper) revealed that, while the checks on the power of any one government provided by the Federation is valued, the way governments work together could be improved, especially in the design of policies that affect the delivery of public services.

The consistent messages from the stakeholders included:

- The need for all governments to either get out of one another's way, or if there was a genuine need for multiple governments to be involved, there should be a co-design of policies, to ensure they were done well and were the right fit, accompanied by mutual respect for each other's competence and contribution.
- Related to this, the importance of preserving diversity as to how services are designed and delivered—taking account of local considerations, cultural sensitivities, and that all providers should have a freer hand to design, or adapt, services based on what was actually needed at the local level.
- The importance of clear responsibility and public accountability and the role of independent mechanisms (like independent bodies or institutions) to provide clear and easily understood information on the performance of all governments, including how governments are spending their money—participants were more reassured when independent and credible bodies that were at 'arm's length' from all governments had a role in reporting on their performance.
- The need for all governments to provide durability of funding and policy direction, while still allowing room for different governments to implement their electoral mandates—participants felt competing policy agendas did more harm than good in improving services, and there was far too much chopping and changing by governments on their policies and how services were delivered, which meant they could never really have any certainty about their funding, see anything through, or plan well for the future.
- The desirability of the Commonwealth continuing to play a national leadership role by bringing the States and Territories 'to the table' to seek agreement in the setting of high level policies and strategies, national goals and standards (whether they were funding, quality, performance or achievement, reporting, content or regulatory standards)—participants considered that a range of important national policies or architecture would 'collapse' if the Commonwealth withdrew.

All agreed that any reallocation should not just be a 'rearranging of the deck chairs', or a theoretical exercise in changing what already exists.

The overarching goal should be to ensure governments have the right incentives to continuously improve the services provided to Australians, which in turn will improve their wellbeing and standard of living.

This goal was ratified by the Council of Australian Governments (COAG) at its meeting on 17 April 2015, where it “agreed the goal of Federation reform is to improve the standard of living and wellbeing of Australians through better services”.¹¹

Stakeholders frequently stated that too much of their time was taken up sorting out the requirements of the different levels of government, both trying to achieve the same outcome in the same area.

In the end, it is not clear to the person on the street—the patient, the student, the tenant—who is responsible for what.

Numerous commentators, including the Business Council of Australia¹² and the Committee for Economic Development of Australia,¹³ have also cited the overlap and duplication caused by the involvement of multiple levels of government in a policy area, and that more consideration needs to be given to the effect this has on businesses and service providers.

The result is less efficient, more costly, and in some cases, poorly coordinated, services.

If the goal of this reform process is to improve the services provided to Australians, the first question to ask is what prevents this from happening now?

One of the largest problems intruding on the delivery of better services to Australians is how the current arrangements within the Federation are structured and the impact this has on the incentives within each sector—whether the current roles and responsibilities create strong incentives for better quality services that are delivered efficiently and support a strong economy.

This, therefore, requires a careful assessment of who is responsible for what, how those responsibilities are being carried out, and how this drives the behaviour of key players in the sector.

In some instances, roles and responsibilities between the Commonwealth and the States and Territories are clearly delineated. For example, in higher education the Commonwealth’s role as the major player in the system is uncontested and universities—most of which are established under State and Territory legislation—deliver services independently.

In other sectors, however, roles and responsibilities are increasingly shared or overlapping.

The Issues Papers on education, health, and housing and homelessness (released in December 2014) showed there is overlap and duplication in these areas, where governments share responsibilities and roles within those responsibilities.

¹¹ Council of Australian Governments, *COAG Communiqué, 17 April 2015*, COAG, Canberra, 2015, <<https://www.coag.gov.au/sites/default/files/COAG%20Communique%2017%20April%202015.pdf>>.

¹² Business Council of Australia, *Action Plan for Enduring Prosperity*, BCA, 2013, p.53

¹³ Committee for Economic Development of Australia, *A Federation for the 21st Century*, CEDA, 2014, pp. 51, 68, 105.

If the challenge is to develop a set of arrangements that allow for better services to be designed and delivered for all Australians, then consideration should be given to the best way to determine the configuration of roles and responsibilities to achieve this.

One of the weaknesses in how roles and responsibilities in Australia's Federation have evolved is that they have largely arisen based on governments' separate desires to take on for themselves a specific role, to initiate a specific policy or programme in a particular area of responsibility, or in response to a specific issue, rather than being a consequence of genuine collaboration between governments to co-design reforms.

This has led to an increased blurring of roles and responsibilities between the Commonwealth and the States and Territories, with each level of government performing different, or in many cases, overlapping functions.

At its worst, these kinds of blurred arrangements have meant:

- there is no way of governments looking at how the whole system comes together, how it is working for Australians, and whether the incentive structures within the system are the right ones to ensure the delivery of the most efficient and high quality services;
- different governments have license to, and are usually tempted to, pursue the objectives that matter most to them in exercising their roles and responsibilities which often compete with another level of government's objectives for the same sector, and which organisations delivering the front-end services to the public often have to try to reconcile, or make sense of, by themselves;
- there are incentives for one level of government to shift costs to another, leading to higher costs and lower quality services for Australians;
- there is often 'buck passing' between levels of government, meaning no one really knows who is responsible for what; and
- the incentive structures in the system are usually (but not always) geared towards governments' interests, or have been shaped in response to advocacy by providers, rather than being focused on what Australians need and want, including choice and having a voice in how services are designed and delivered.

Finding success stories that demonstrate how these kind of blurred arrangements have worked, and translated to actual improvements in the delivery of services, is hard.

There have been some successes for collaboration in joint areas of responsibility, including the National Competition Policy, gun control reforms in the wake of the 1996 Port Arthur tragedy, and the AIDS campaign in the 1980s.

More recently the structured collaboration on the design and implementation of the National Disability Insurance Scheme (NDIS) is a good example of successful cooperation. These, however, are not widespread across other areas of responsibility.

Instead, many advances in the delivery of better services have come through competitive forces within the Federation, rather than through genuine or deliberate efforts from governments to co-design and collaborate upfront on policies of shared need.

It is not necessarily a bad thing to have competition between State and Territory governments driving service delivery improvements. Reforms that are shown to work in one jurisdiction can put pressure on other States and Territories to adopt similar reforms, resulting in a 'race to the top' in the delivery of services to the public.¹⁴ The failure of some programmes can also assist other jurisdictions in avoiding pitfalls, or observing how some of the incentives in the system have actually been working against the provision of better services.

In terms of the Commonwealth's involvement in the development of shared arrangements, it has largely been 'horses for courses' and has usually depended on how important it considered the issue to be.

It varies between providing leadership in complex national markets and policy areas—where leadership could mean a more 'light touch' role in facilitating the development of national standards—to taking a far more 'hands-on' and direct role in areas such as the delivery of services specifically aimed at assisting Indigenous people.

If getting the incentives right for improved service delivery for Australians is the main game, a better approach would see all governments working together upfront to co-design reforms, systems and markets; roles and responsibilities for each level of government would then be rationally and deliberately determined as a consequence of that.

This is what the Reform of the Federation White Paper is trying to do now, within our existing constitutional framework.

This could include governments agreeing that either (1) one level of government is solely in charge of the system, with the other level of government 'vacating the field' and getting out of the other's way, or (2) where this is not practical for various reasons, governments better coordinating and formally sharing their efforts with an eye on greater equity, efficiency and effectiveness in delivering outcomes to citizens, or (3) some combination of both approaches.

This kind of approach would mean that the commitment to ensuring the allocation of roles and responsibilities is amplified; all governments would have some 'skin in the game' and have a mutual interest and common goal in ensuring that the configuration of roles and responsibilities—including the incentive structures—are right to deliver services well.

The current state of federal financial relations, and the degree of the Commonwealth's financial power in the system which makes the States and Territories dependent on it to finance their spending

¹⁴ A Twomey and G Withers, *Federalist Paper: 1 Australia's Federal Future*, Council for the Australian Federation, 2007, p. 9

responsibilities, contributes to the complexity of our federal system. It creates perverse incentives that make genuine intergovernmental partnership difficult.

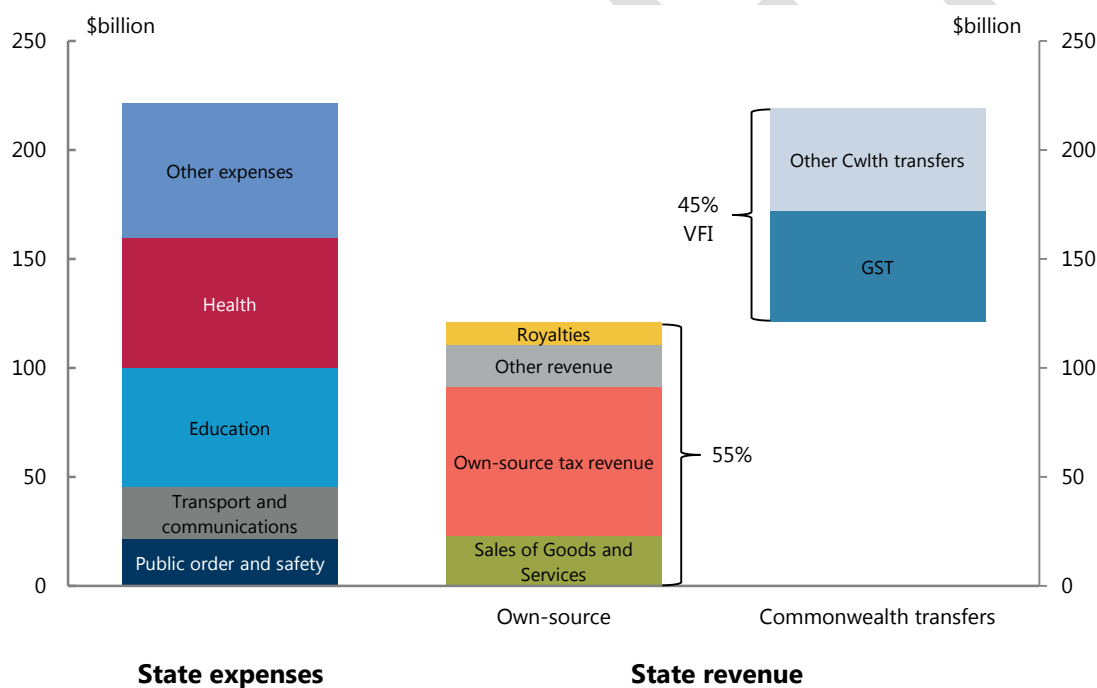
This underlying structural feature of our Federation—the mismatch between revenue and expenditure responsibilities between the different levels of government—is known as vertical fiscal imbalance (VFI), which is discussed in more detail in *Chapter 5: Federal financial relations*.

Australia's degree of VFI is very high by international standards.

The Commonwealth raises 82 per cent of total tax revenue, the States and Territories raise 15 per cent and local governments the remaining three per cent.¹⁵ By contrast, in Canada (another federation with similar characteristics to us), the central government raises only 45 per cent of total tax revenue.

Further, Commonwealth transfers (including the GST) comprise about 45 per cent of total State and Territory revenue, as demonstrated by Figure 1.1 below.

Figure 1.1: VFI—States spend more than they raise and the Commonwealth fills the gap, 2013-14



Source: State budget papers; ABS. cat. no. 5512.0, and Commonwealth Final Budget Outcome 2013-14. 2013-14 data

While there is no 'easy money' to be found by governments, there are arguments that can be made about whether all governments are using their tax bases as efficiently as possible—the current

¹⁵ Australian Bureau of Statistics, *Taxation Revenue, 2013-14*, cat. no. 5506.0, ABS, Canberra, 2015.

situation sees the States and Territories rely on the Commonwealth to fund a large proportion of the delivery of their services.

Australia's high degree of VFI is a problem because it can create a situation where the States and Territories blame the Commonwealth for not passing on enough funds to deliver their services, or where the Commonwealth can blame the States and Territories for not using taxpayers' funds properly (blame shifting).

This is compounded by the ability of the Commonwealth to attach detailed conditions, or matching requirements, to funds—in effect constraining the flexibility and manner in which a State or Territory spends, not only Commonwealth, but State or Territory money. While the Commonwealth has made considerable use of its superior fiscal power in the Federation, the States and Territories have generally responded in such a way that suggests they would rather have the funding—with the conditions—than not have the funding at all.

Addressing the mismatch between revenue and expenditure in Australia would go a long way toward ensuring governments can no longer shift the blame of policy failures and the costs of policy responses between them.

This is one reason why the relationship between the Commonwealth Government's Reform of the Federation White Paper and the Tax White Paper is so important.

The Tax White Paper is looking at revenue for all levels of government through a comprehensive analysis of Australia's tax system. The Federation White Paper is looking at expenditure responsibilities and how revenue should be shared between governments so they can meet these responsibilities. Given the link between the two, the Federation and Tax White Papers are being progressed together.

As the current arrangements now stand though, they leave Australians with a confusing type of federalism that may make some kind of sense to some bureaucrats and academic experts but leaves the public—the ultimate users of the services—with services that do not have the right kind of incentive structures or perhaps are not designed or delivered as well as they could be, and unclear about who is responsible for them.

Ultimately, Australians want high quality public services—regardless of who delivers them—but they also want to know who is responsible when those services are not up to standard or fail to deliver.

The Federation as it currently operates does not always allow this to happen.

1.3 A Federation for our future

Reform of the Federation will be worthwhile if it improves the incentives to deliver better services, enhances the accountability of all governments to Australians for taxes being well spent, drives productivity improvements and economic growth, and improves the way governments work together.

Australians should be able to clearly identify who does what, and what they should reasonably expect to have provided by their different levels of government.

The relationship between governments and Australians has changed since Federation and will continue to do so.

Australians now are more informed than in the past and are demanding better services.

They are not only demanding more and better services from government, they are also demanding more choice from governments, not just a 'one size fits all' service.

Given the current fiscal circumstances faced by all governments, Australians want those services delivered as efficiently as possible, so that taxes and user-charges are not higher than they need to be.

That means getting the incentives for governments, and other service providers, right. It also means that accountability to Australians for the delivery of those services should be enhanced.

What's needed, therefore, through this White Paper process is a re-think on how roles and responsibilities within the Federation are designed and allocated to deliver better services for all Australians.

CHAPTER 2: IMPROVING AUSTRALIA'S FEDERATION— HOW TO DESIGN THE NEW ARRANGEMENTS

2.1 Process leading to the Green Paper—consultation and collaboration

A reform process of this significance—which has the potential to fundamentally affect the lives of Australians—demands genuine collaboration and consultation across all levels of government and with the public.

Ensuring the voices and perspectives of the ultimate users of the Federation are heard is critical to the success of its reform.

It is also important to harness the significant expertise and experience of those who work within the Federation, and those who think more deeply about it as an academic or professional discipline.

From the outset, the process has been characterised by strong and close consultation between the Commonwealth, the States and Territories and the Australian Local Government Association, under the auspices of the Council of Australian Governments (COAG)—starting with the development and release of the White Paper's Terms of Reference on 28 June 2014 (provided at Appendix 1).

The reform options in Chapters 3, 4, and 5 are presented 'without prejudice' with a view to generating public discussion about how reform of the Federation should proceed.

In the lead up to the Green Paper, five Issues Papers were developed, also in close consultation with States and Territories, and released between October 2014 and February 2015.

These traced the development of the Federation since 1901, provided a factual account of the key policy areas being examined, and asked a number of questions about the current arrangements.

It was not their purpose to outline any potential solutions or reform options—that is the purpose of this Green Paper. Similarly, the Green Paper does not seek to replicate the detailed analysis of the Issues Papers.

The Issues Papers framed discussions at ten stakeholder consultation roundtables held in February and March 2015 in each capital city, Townsville, and Wagga Wagga.

A general summary of the feedback received during these conversations is at Appendix 2. Where more concrete solutions were proposed, these have been considered in context of the range of reform options outlined in Chapters 3, 4, and 5.

The advice and opinions of the Prime Minister's Expert Advisory Panel (see Appendix 3) has also guided the process along the way.

These independent Panel members have been closely involved throughout the process, meeting with all Premiers and Chief Ministers through COAG, participating in stakeholder roundtables, and providing advice to the Prime Minister on what reform options could be considered.

2.2 How best to go about designing any new arrangements

What sectors have been considered?

This Green Paper focuses on the key sectors identified in the Terms of Reference—health, education, and housing and homelessness.

These are the key areas of social policy which provide universality of services to Australians, have high levels of expenditure from all governments, and where there is a significant degree of overlap in roles and responsibilities between levels of government.

There were a range of other areas also identified as within scope, but to a lesser degree, in the Terms of Reference—transport infrastructure, Indigenous affairs, justice, disability, welfare services, settlement services, family and parental support, disaster recovery, environmental regulation, adult and community education and youth transitions.

As the process progressed, it was recognised that many of these areas are already being reformed or reviewed through other processes, or already have formally agreed roles and responsibilities between the Commonwealth and the States and Territories. For example, the Productivity Commission has recently issued reports on transport infrastructure, justice and disaster recovery which has precipitated consultation between the Commonwealth and the States and Territories in these areas.

Similarly, in other areas like the National Disability Insurance Scheme and the one-stop-shops on environmental regulation, there are already formal and co-designed arrangements governing how governments work together in these shared spaces.

In other areas, like settlement services, adult and community education, and youth transitions, analysis revealed no significant overlap in roles and responsibilities of the different levels of government. As such, and in the context of an already crowded agenda, further consideration was not necessary at this stage.

The reform options set out in *Chapter 3: Governance and accountability* (on how governments could work better together on co-design), and the preconditions for reform set out below in this chapter (which aims to improve the way governments work better together), give a useful framework that could, in future, be applied to some of these other policy areas. For example, they could be considered by COAG as priorities in its medium-term agenda (see reform Option 1, Chapter 3).

With regard to Indigenous affairs, Aboriginal and Torres Strait Islander people commonly access mainstream services which are expected to cater for the needs of all Australians. These services, however, are supplemented by Indigenous-specific services provided by the Commonwealth and the States and Territories in recognition of the particular cultural requirements of Indigenous Australians and the high level of disadvantage—especially in remote areas.

In recognition of the commitment of all governments to improving outcomes for Indigenous Australians, services for Indigenous Australians are considered as part of the discussion in health, education, and housing and homelessness in *Chapter 4: Key areas for reform*.

The basis for decision-making

The White Paper's Terms of Reference set out a number of principles to be applied when allocating (or re-allocating) roles and responsibilities between different levels of government—accountability; subsidiarity; national interest considerations; equity, efficiency and effectiveness of service delivery; durability; and fiscal sustainability.

As discussion took place between the different levels of government, the Expert Advisory Panel, and key stakeholders, it became clear that, while these principles were useful in considering the more technical design aspects of the Federation, something more practical was needed to connect any reform options back to their overarching purpose.

Consequently, in April 2015, as part of its agreement that the goal of Federation reform is to improve the standard of living and wellbeing of Australians through better services, COAG agreed that any reallocation of responsibilities between governments should aim to:

- **deliver better services:** recognising diversity as a strength of Federation, it should be easier for people to receive, choose and access high quality services;
- **drive economic growth:** encourage a productive and efficient economy supporting growth in the standard of living for all Australians;
- **be fair:** all Australians should be able to receive, choose and access high quality services, regardless of personal circumstances, location or socio-economic background;
- **provide clear responsibility:** people should be clear which level of government is responsible for services so they can hold them to account; and
- **be durable:** arrangements need to stand the test of time and be adaptable and flexible enough to accommodate changes required over time.

These criteria have been used as the basis for developing, selecting, and assessing the reform options outlined in Chapters 3, 4, and 5.

It is usual in tasks of this nature that, to arrive at an overall and balanced assessment, sometimes individual considerations 'rub up' against one another, and trade-offs are required to achieve the ultimate ambition.

The process of selecting and assessing reform options in such a dynamic federation as Australia cannot ever be an exact science, but it can be balanced and rational.

While these criteria have underpinned the consideration of the expenditure side of the equation (that is, who is allocated roles and responsibilities to deliver), there will be different considerations required on the revenue side (that is, how funding to deliver on these roles and responsibilities is generated).

In considering how revenue is distributed between the States and Territories, the White Paper will keep in mind that each level of government should have sufficient revenue to finance their own expenditure responsibilities, including any changes to those responsibilities arising from any reforms. *Chapter 5: Federal financial relations* proposes several options for improving current arrangements.

How reform options were developed

Before getting to an individual assessment of reform options it is important to reflect on the big picture, and ask how can governments work better together across all sectors where collaboration is genuinely needed.

The following chapter (*Chapter 3: Governance and accountability*) discusses in more detail how governments can do this but, at a minimum, this sort of approach will require:

- **Policy co-design and analysis:** Governments with a stake in a policy area should be genuine co-designers of reform. They should be engaged early in the policy development process to build a shared understanding of how the system works, or should work. Recognising that a response to a policy problem does not always need government involvement, non-government players should also be involved in the co-design process, where appropriate. If government intervention is required it should be clear which level of government is undertaking which role, and for what purpose. Co-design and analysis should also consider up-front how the policy should be implemented and delivered (rather than as an afterthought which can often be the case), including how it can be tailored to meet local circumstances.
- **Availability of and access to data:** Governments should collect and share data to inform policy co-design and analysis. The available information should provide a complete picture of the entire system, and inform consumers' choices. The data should allow governments to understand who is using services and programmes, how they are being used, and what outcomes are being achieved. This will allow programmes and services to be targeted to, and tailored for, the people who need them the most.
- **Risk sharing:** All levels of government should understand the risks that governments assume in the design of a particular system. There should be a mature and agreed approach to how the risks will be shared at the policy co-design phase. In the end, there are no pay-offs from blame-shifting between levels of government.
- **Valuing consumers' voice and choice:** In designing arrangements, user choice should be placed at the heart of service delivery. Governments should aim to enhance consumers' capacity to influence the way services are delivered, and empower them to choose from a diverse range of service providers. It should not be assumed governments need to deliver services—often the

not-for-profit and private sectors will be better placed to do so. Healthy competition and proper market design for the provision of services can encourage innovation and improve the quality of services in the long run.

- **Transparency and provision of public information:** Governments have a responsibility to ensure systems are designed to ensure clear information is provided to the users of the system and that the systems can be easily navigated. It should be clear to the public who is responsible for what in any system. This should be done through integrating public reporting in the policy co-design stage, rather than as an ‘add on’ to suit government requirements, or only to meet government-to-government accountability or performance requirements.

In considering the possible reform options in health, education, and housing and homelessness, the following questions were asked:

- How does the sector perform now?
- How does it work within the current arrangements in the Federation?
- What kind of system do we want to end up with, and what might a shared vision or reform ambition look like?
- How can reforming the Federation help achieve this and what are the possible reform options that governments could consider, or is government involvement required at all?

Chapter 4: Key areas for reform, follows this structure. Without going into all the detail of the issues papers, it briefly describes the sector, its composition, and how it is performing now—the general pressures within it and whether the incentives in the sector are the right ones to promote the delivery of the most efficient and high quality public services.

It then looks at how current Federation arrangements affect the sector. Not all of the problems in these sectors arise through the Federation—it is therefore important to recognise the specific challenges caused by the Federation so we are clear about which of these the White Paper process can start to resolve.

The reform ambition for each sector is then considered, and finally how the White Paper process can move the system in the right direction towards this ambition; what reform options might be needed to do this; and what the role of governments (if any) in this might be.

The reform options have been identified by the Commonwealth, in close consultation with the States and Territories, the Prime Minister’s Expert Advisory Panel and a range of stakeholders.

They are those that could be achieved by rethinking who does what in the Federation and applying the criteria endorsed by COAG—better services, economic growth, fairness, clear responsibility and durability. Some other options are outlined that were considered but, for various reasons, have not been presented as formal options for consideration.

While a range of reform options have been presented, this does not mean they are supported or agreed by all levels of governments as the solution, or that they must be pursued through the Federation White Paper.

It is likely there will be no perfect solution, but ambitious reform options that will create real change and genuinely improve services should be pursued.

This could be through a single major reform, or a series or combination of reforms.

The options in the Green Paper encompass both these approaches. They are not intended to be an exclusive list for Federation reform, nor are they mutually exclusive—some options, in fact, could be progressed together and may work best in combination with others.

It is also important to remember that reforms of this magnitude cannot be rushed and some may take many years to fully develop and implement and require careful transition arrangements. Some of the options could be considered initial, incremental steps—implemented sooner—on the way towards more far-reaching changes. In many cases, this kind of incremental approach, supported by necessary transition arrangements where needed, is likely to be more sustainable and effective than moving too quickly.

This goes to an important point about the process of reforming the Federation—it is an ongoing and incremental process. System-wide reform cannot be expected to be achieved as one ‘big bang’ moment.

Trade-offs between the different policy areas and financial considerations are also likely to be needed. The success of any reforms that looks at reallocating expenditure responsibilities to different levels of governments requires those governments to have sufficient revenue to finance them.

Possible reforms to federal financial relations—how revenue is distributed to and between States and Territories—that can help reforms to expenditure responsibilities stand the test of time are set out separately in *Chapter 5: Federal financial arrangements*.

Regardless, it will take a sustained commitment from all levels of government and all sides of politics to see sensible reform through.

In drafting the descriptions for each option, it has been a challenge to strike the balance between providing enough information—giving a clear idea of the proposal—but not too much detail, allowing sufficient room for stakeholders to offer alternative implementation pathways or variations on the option.

Some of the proposed reform options are quite technical in nature, given the complexity of the sectors in which they would operate. Every effort has been made to present the information simply and clearly, noting that some of the more technical issues will need to be discussed with relevant experts and worked through by governments should those reform options be pursued. For some of them, ‘the devil will be in the detail’.

With that in mind, it is hoped that the advantages and disadvantages of the ideas can be tested, and suggestions can be elicited through the public submissions process, from stakeholders and experts on how they could work in practice.

Views are sought on which options are preferred and whether there are any others that should be considered.

CHAPTER 3: GOVERNANCE AND ACCOUNTABILITY

3.1 How do the Federation's governance and accountability arrangements work now?

Our Federation has been integral to Australia's success as a peaceful, prosperous and democratic society. Governments have worked well together to help deliver a high standard of living for Australians.

That's not to say that the relationship between the Commonwealth and the States and Territories has always been smooth, but the benefits of collaborative approaches are numerous.

The National Competition Policy reforms of the 1990s were landmark economic reforms. Supported by successive governments at all levels, they improved our national productivity and competitiveness to the benefit of all Australians. There have been other examples of successful cooperation since then, including major tax reform, gun control, the National Disability Insurance Scheme, and counter terrorism efforts, as discussed in *Chapter 2: Improving Australia's Federation*.

These considerable achievements came despite Australia having no formal federal governance system, which has been noted by various commentators.¹⁶

The evolution of Australia's modern Federation means there are now many more areas of shared responsibility between the Commonwealth and the States and Territories than the constitutional drafters ever imagined. Changes in technology and transport have connected Australians more to one another and to the world and Australians are increasingly integrated into the global economy and community.

As discussed in *Chapter 1: The challenges facing Australia's Federation*, our current federal arrangements have evolved largely based on judicial interpretations of the Constitution and various governments' desires to take on specific roles, or initiate specific programmes in response to issues of the day. This has led to a mismatch between revenue raising capacity and expenditure responsibilities. They have been less the result of coordinated planning than an evolution and collection of ad hoc responses to the political and economic circumstances over time.

That is not necessarily a bad thing, but it has led to an increased blurring of roles and responsibilities between the Commonwealth and the States and Territories.

Governance arrangements establish the 'rules of engagement' between governments and, to a certain extent, attempt to encourage and support rational and effective behaviour. Poor governance

¹⁶ See, for example, Business Council of Australia, *Reshaping Australia's Federation: A New Contract for Federal State Relations*, Melbourne, 2006, Appendix 1. Similar feedback was also received through the stakeholder roundtables. Summaries of the stakeholder observations are available at Appendix 2 to this Green Paper and <http://federation.dpmc.gov.au/stakeholder-roundtables>

arrangements can, however, encourage the ‘blame game’, create perverse incentives and, at worst, lead to inefficient and inequitable outcomes.

There is considerable attraction in aiming to cleanly and clearly separate and allocate roles and responsibilities to tiers of governments as much as possible. It helps Australians hold their governments to account. It reduces opportunities for governments to shift blame and costs.

But ‘clean lines of accountability’, whereby one level of government has full responsibility for a particular area of publicly funded activity, can undermine one of the benefits of federation, namely the dispersion of power. When more than one level of government is involved in a particular area, it allows citizens to ‘hedge their bets’, so to speak, by giving them more than one avenue of redress when something goes wrong with the way one level of government is performing.

So a ‘clean lines’ approach should not be the sole goal of federation reform. In particular, it shouldn’t come at the cost of diminishing services for Australians. The best of both worlds is better services and clearer responsibilities.

If improved service delivery for Australians is a high priority, the question to be asked is whether the Federation’s existing governance arrangements (and the institutions within those) are fit for purpose and functioning the best they can.

Do they create the right environment for governments to work together to co-design systems and markets that deliver better quality services to Australians?

These kinds of governance arrangements can be considered largely ‘back office’ or bureaucratic arrangements—most Australians are unlikely to get excited by the workings between governments, so long as they receive the services they need. They are, however, fundamental to the effectiveness of the Federation and how governments are able to work together.

Without them, any reforms will be left to political circumstance. There certainly wouldn’t be durable national reforms, and reforms would be unlikely to deliver better services, drive economic growth, be fair, or deliver clear responsibility.

This is why the discussion on reforms in this Green Paper begins with the way governments work together.

Getting these arrangements right is critical to enabling the long-term success of the reform options outlined in health, education, and housing and homelessness in *Chapter 4: Key areas for reform*, especially those where there are shared responsibilities.

Governance arrangements and institutional architecture

Intergovernmental cooperation between the Commonwealth and the States and Territories has evolved largely on the basis of unwritten conventions, with the Special Premiers Conferences of the early 1990s and, today, the Council of Australian Governments (COAG), operating without an agreed set of formal rules.

COAG is the major platform for reforms of national significance that require cooperation by all levels of

government. Since its inception in 1992, COAG has helped achieve some major reforms including, as previously noted, the National Competition Policy.

Notwithstanding these achievements, COAG's operation has been criticised for being too transactional and adversarial, and for often being preoccupied with stoushes about amounts of funding as opposed to the most effective and efficient use of that funding. This view is reflected in public sentiment—many Australians think governments do not work well together.¹⁷

Many also believe that COAG should have a tighter strategic focus on nationally-significant issues and have called for more certainty around its operations, more durability in the agreements it reaches, and more collegial and rational decision-making.¹⁸

A more formal framework underpinning how governments work together won't necessarily guarantee that intergovernmental relations will never be vulnerable to short-termism and over-dependence on individual leaders. But a more formal framework should make it easier for those leaders to support necessary long-term policy reforms and can encourage the cultural change necessary for reforms to be developed and implemented over time.

Accountability within the Federation

All Australian governments should be able to get on with delivering their responsibilities, with appropriate levels of accountability to the Australian people given the magnitude of funding at stake. In 2012-13 total government spending on health alone was over \$100 billion.

The *Intergovernmental Agreement on Federal Financial Relations* (IGA FFR), introduced in 2008, was an attempt to formalise governance arrangements between the Commonwealth and the States and Territories. It also introduced a set of rules to improve public accountability. In addition to the public accountability arrangements under the IGA FFR, all governments are accountable to their own parliaments, including through auditors-general, for the use of taxpayers' money.

The IGA FFR sought to give States and Territories more flexibility in delivering services through an improved focus on accountability for better outcomes and service delivery. It sought to reduce Commonwealth prescriptions on State and Territory service delivery and financial reporting to the Commonwealth. This was intended to create incentives for efficient investment to achieve outcomes and ensure solutions were tailored to local circumstances.

The IGA FFR also sought to clarify the respective roles of each level of government and consolidated a range of financial transfers from the Commonwealth into a streamlined and generally more efficient system.

Initially, there were achievements under the IGA FFR. A large number of disparate agreements were consolidated into six broad 'National Agreements'. With the exception of Indigenous welfare, these

¹⁷ Griffith University, *Australian Constitutional Values Survey*, 2014.

¹⁸ See, for example, George Williams and Paul Kildea, 'COAG: How to turn a 'parking lot for tough decisions' into something really useful', *The Conversation*, 24 March 2011.

agreements were complemented by ongoing semi-tied funding streams, called National Specific Purpose Payments (NSPPs).

There were also about 20 National Partnership Agreements (NPs)—separate agreements and associated payments aimed at rewarding reforms or supporting improvements in service delivery.¹⁹

While there remains solid support among governments for the objectives and principles of the IGA FFR, there is also agreement that it has fallen short in its implementation. A relatively short period after the agreement was signed and legislated, several major reforms in areas of shared interest—namely health reform and changes to schools funding—were agreed outside the bounds of the IGA FFR.

Moreover, while the Commonwealth clearly signalled that funding provided through the NPs was short-term and would not necessarily be extended,²⁰ public expectations were raised that the States and Territories were not always able to meet. The number and reach of these NPs also spread beyond their original intent, contributing to a further blurring of lines of accountability within the Federation, as to who was responsible for funding and providing services.

Arguably most importantly though, governments did not promote the cultural or behavioural change that was required to fully implement the IGA FFR, perhaps underestimating how important this kind of change was to its success. For example, often ‘accountability’ within the Federation is seen as States and Territories being accountable to the Commonwealth for funding or performance—that is, for achieving what the Commonwealth believes to be the ‘right thing to do’. Instead, accountability should primarily be about the accountability of all governments to the public for the outcomes they deliver.

This was one of the central goals of the IGA FFR.

It structured National Agreements and NPs on the achievement of outcomes (and to a lesser extent outputs), rather than inputs (how funding was to be used or what it should be spent on). For example, the *National Partnership Agreement to Deliver a Seamless National Economy* provided ‘reward’ payments to the States and Territories for pursuing agreed reforms in business regulation and competition.

Reporting under the IGA FFR was also supposed to be outcomes-focused—on what was achieved rather than on how something was funded, or the nature of a product or service that delivered the outcome.

The aim was to help the public understand whether reforms undertaken by the Commonwealth and the States and Territories were improving outcomes for Australians.

¹⁹ See *Issues Paper 5: COAG and Federal Financial Relations* for further information on the IGA FFR.

²⁰ The IGA FFR anticipated that for National Partnerships ‘where ongoing funding is required to maintain a new level of output, such funding may more appropriately be provided through the relevant National SPP Agreement or general revenue assistance’. This has not occurred to date.

But many agreements under the IGA FFR were short term, or had underdeveloped and inadequate performance measures or data sources, making it difficult to track progress.

This led to inconsistent approaches by the Commonwealth and the States and Territories.

In particular, the Commonwealth struggled to make the adjustment required to focus solely on outcomes and was uncomfortable with being 'hands off' in prescribing how funding was to be used. Broadly speaking, the Commonwealth felt it was not receiving enough information to properly assess performance, which led to the Commonwealth seeking further reporting from the States and Territories and attaching more conditions to payments.

For their part, the States and Territories felt the Commonwealth was being too prescriptive, making overly burdensome information requests, and specifying too many conditions on how outcomes were to be delivered and achieved.

The COAG Reform Council (CRC) was established as a key platform in the IGA FFR to improve public accountability. Its intended task was to complement the focus of the IGA FFR on outcomes and report on the progress of governments in achieving agreed outcomes (or where these were not specified or difficult to measure, major outputs). The flaws in the performance frameworks, including problems with timeliness of data, however, meant the ability of these reports to drive reform was limited.

While the CRC did promote more effective ways for governments to work together, there is little evidence that governments improved their performance in direct response to the CRC's findings.²¹ Additionally, there is already a considerable amount of publicly available material that broadly covers the same information addressed in the CRC's reports—including the Report on Government Services, annual reports on the performance of schools and hospitals, and Australian Bureau of Statistics publications.

While ultimately many of the ideas and intent behind the IGA FFR were on the right track—to create a national framework for the way governments work together, how funding is transferred, and high levels of transparency and accountability for how all governments perform against that framework—on this occasion, the theory did not translate into practice. It did, however, establish some of the preconditions for how governments can work together.

For now, though, important national reforms are implemented sometimes despite governance arrangements, not because of them—with governments focused on accountability to each other, rather than for the services and outcomes they deliver to the people who elect them.

3.2 What could better governance and accountability arrangements within the Federation look like: options for reform

As discussed above, strong governance arrangements are important if governments are to work together in the Federation to improve services for Australians.

²¹ The CRC was abolished in the 2014-15 Commonwealth Budget.

They are also critical in ensuring governments are accountable to the public and to help ensure any changes to government roles and responsibilities, such as the options set out in *Chapter 4: Key areas for reform*, are durable and have the best chance of succeeding.

Three governance reform options are presented for consideration below. They were developed in close consultation with the States and Territories, the Australian Local Government Association and the Prime Minister's Expert Advisory Panel, and draw on discussions at the stakeholder roundtables. The way the options were developed is set out in *Chapter 2: Improving Australia's Federation*.

When considering which options are best, it is important to be mindful of the five criteria identified by COAG, namely to deliver better services, drive economic growth, be fair, provide clear responsibility and be durable.

Other options that were considered through this process, but are not formally being put forward, are also described briefly at the end of this section.

For ease of presentation, these options are set out individually. This does not mean they are mutually exclusive. Indeed, the options could be pursued together or aspects of them could work well in combination with other options.

The order in which the options appear does not indicate any preference.

Option 1: Clarify the role of COAG and formalise how COAG could work better

Under this option, the role of COAG and its operations would be formalised through a Federation Compact, akin to mutually agreed terms of reference, to guide the way governments work together. It would potentially cover matters such as:

- a clear statement clarifying the role of COAG;
- behaviours to be demonstrated by all Australian governments when dealing with each other;
- a regular meeting schedule;
- a medium-term agenda focused on matters of strategic and national significance;
- an agreed process for determining individual meeting agenda; and
- a commitment to transparency through the public release meeting agenda before meetings, and a communiqué afterwards.

This option would formalise and codify the role of COAG and how it works, and set out clearly the 'rules of engagement' that all governments agree to abide by when interacting with one another through the COAG process.

The Federation Compact could describe COAG's role and include a set of behaviours that the public could rightly expect of their governments when engaging with one another, based on mutual trust and respect for each other's competence and contribution.

They would also enshrine for the public the way they expect their governments to behave, give them a touchstone on which to assess this behaviour, and support the public's trust in the effectiveness of Australia's political leadership.

Such a Compact would provide a missing piece of the underpinning authority for how COAG works. As a public decision-making body, COAG is an outlier in that it doesn't have a formal operating procedure to guide it.

As the peak governance body for Australia's federal system, improvements could also be made to the way COAG works to ensure it is a more strategic and cooperative decision-making forum working in the public's interest.

While COAG has already agreed to meet at least twice a year—usually around April and November—this could be formalised to provide more certainty for all governments and the public.

Agreeing to a regular meeting schedule would not preclude additional meetings for urgent matters requiring a national response. There will sometimes be the need to quickly address issues of immediate and genuine national concern. For example, during the global financial crisis, COAG was able to respond quickly.

COAG needs to be able to both manage national issues as they arise, and have an eye to the future and facilitate collaboration on longer-term shared and more strategic challenges.

Developing a medium-term agenda for COAG would allow governments to do this—it would shape a longer-term reform plan beyond COAG's immediate priorities and address the problem of it becoming too 'transactional'.

Such an agenda could be publicly released and reviewed annually by COAG, along with progress made against matters on the agenda. This would increase public understanding of COAG's longer-term priorities.

How the COAG agenda is determined could also be formalised to ensure it is focused on a small number of strategic issues of genuine national significance, rather than just 'hot button' political topics being pushed by particular jurisdictions.

The Compact could also codify the process for determining meeting agendas, including the existing arrangement where all members are invited to nominate items for discussion before each meeting. It could also require the agenda to be released before each meeting so the public knows what will be discussed by their leaders.

Option 2: Affirm and strengthen the Federation's institutional architecture

The IGA FFR could be revised and reaffirmed to:

- commit all governments to a new set of overarching federal principles, based on those contained in the IGA FFR;

- better describe Australia's intergovernmental arrangements, including roles, responsibilities and institutions; and
- improve implementation and oversight of intergovernmental funding arrangements to ensure the durability of funding arrangements.

This option could improve the Federation's institutional architecture and strengthen the durability of intergovernmental arrangements.

The implementation of this option would, however, need to be accompanied by the necessary cultural change that was missing from previous reform attempts.

Under this option, overarching principles for Australia's Federation would be established to describe the purpose of our federal arrangements and the kind of Federation we aspire to be. While not being binding rules, the principles would be intended to provide the 'rules of engagement' and guide governments when they are working together on national priorities.

As well as principles, there could be benefit in better describing the roles and responsibilities of different governments, including any changes to roles and responsibilities arising from the Federation White Paper. Institutions that support the Federation, such as COAG, could also be included, as could the Federation Compact (see Option 1).

As noted earlier, there remains a high level of support among governments for the objectives and principles of the IGA FFR. These could be publicly reaffirmed by all governments as the basis of how the Commonwealth and the States and Territories interact, including in relation to how funding is transferred between the levels of government.

This would also be an opportunity to improve the implementation and oversight of federal financial relations, addressing some of the challenges described further in *Chapter 5: Federal financial relations*.

Option 3: Improved performance reporting and data sharing

Under this option, governments would agree on improved processes for managing data collection, sharing, and dissemination.

The performance of all governments would be assessed against a limited set of meaningful indicators.

Reports using the agreed indicators and data could be published by the Productivity Commission, or by individual jurisdictions (who could tailor the information to the needs of their citizens).

Performance reporting

Improvements can be made to ensure governments are accountable to their constituents and have better information about the effectiveness of their service delivery.

A more robust, comprehensive, and transparent data collection and performance reporting framework, across all levels of government, is needed.

The targeted set of performance indicators could be agreed by COAG. Data in these areas would then be publicly accessible and open for the public to review, comment on, and use for research or other purposes. The public and non-government organisations could then tailor data according to their needs.

It would make responsibilities clearer and could be achieved without placing unnecessary reporting burdens on individual governments.

Governments would spend less time drafting and reviewing lengthy reports, and States and Territories would not be 'reporting to the Commonwealth', but could use the data to develop reports focusing on the interests of their citizens.

A level of consistency between different governments' reports would also be required, to enable the public to compare the performance of governments.

Stakeholders told us they supported the role of independent mechanisms in providing clear and easily understood information on the performance of all governments, including how governments are spending their money. They expressed support for bodies that were at arms' length from all governments in performance reporting, such as the Productivity Commission.

In light of this, as an alternative, the data could be reported to the public in a national report published by an existing body, such as the Steering Committee for the Review of Government Service Provision, which is supported by the Productivity Commission and currently produces the Report on Government Services. The Steering Committee's functions could be extended to include producing more publicly accessible reports on agreed indicators to enhance accountability.

Improved service delivery through better data sharing

When relevant data is not shared between governments in areas of shared responsibility, governments are essentially 'flying blind' and might make policy or spending decisions that adversely affect the other level of government. This can reduce the quality of services for the public.

Improving the way data is collected and shared between governments ought not to be a radical reform. That's not to say it would be easy, quick and inexpensive.

Where possible, data should be reported once and used often.

Some progress is being made, with the Commonwealth, for instance, recently agreeing to share more health data with the States and Territories.

This option looks to build on these efforts and ensure the sharing of data is part of the normal course of business between the Commonwealth and the States and Territories—the default position of all governments should be to disclose and share their data, not withhold it.

The problem is not always an unwillingness to share data—sometimes data is collected differently across jurisdictions. This can mean data is either not comparable, or difficult to use.

Better sharing of good data allows governments to analyse how services are working and this, in turn, can improve the co-design and delivery of services. For example, governments at all levels have major responsibilities for social welfare policy and service delivery, but struggle to synthesise a complete picture of the services and pathways taken by their clients. The Commonwealth's administrative data sets hold valuable insights and evidence in this area, and these could be shared more systematically with the States and Territories. Similarly, the States and Territories have valuable data that could be shared with the Commonwealth.

Governments should share more data to improve government services, provided privacy and commercial safeguards are maintained. As mentioned in *Chapter 2: Improving Australia's Federation*, public reporting of information should ideally be embedded in the policy co-design stage. This would allow governments to understand who is using services, how they are being used, and what results are being achieved. Services could be targeted to, and tailored for, the people who need them the most.²²

Other reform options we considered

A range of other options were considered.

Some commentators have called for the creation of an independent COAG secretariat as an option to formalise COAG's operations. Any benefits from such an arrangement (such as building COAG's corporate memory) would need to be weighed against the cost of establishing a new bureaucratic structure around COAG. The existing arrangement where COAG is supported by a small secretariat within the Department of the Prime Minister and Cabinet is generally considered sufficient by governments.

Another option considered was the establishment of an independent 'Federation Commission' to advise governments on the development and evaluation of national reforms, and monitor the functioning of the Federation. This option has not been considered further because there are existing bodies performing similar functions, including the Productivity Commission.

Proposals for enshrining roles and responsibilities in legislation or the Constitution have also not been considered further. While this could provide greater durability, implementing them would be costly and complicated and they would limit the flexibility of individual governments.

²² This could build on existing work already under way across jurisdictions. The Commonwealth is currently looking into an investment approach to welfare along the lines of the New Zealand model (as recommended in the McClure review of Australia's welfare system). This would involve an actuarial valuation of government interventions. Any such approach in an Australian context would require reference to data and information from service delivery systems across governments.

CHAPTER 4: KEY AREAS FOR REFORM

4.2 Health

How Australia's health system is performing now

Australia's health system is one of the best in the world. Australians live longer than most people²³ and receive high quality health care delivered at a modest overall cost compared with other OECD countries.²⁴

Australians enjoy access to a range of government subsidised services, including general practice (GP) and hospital services, provided by a highly trained workforce. They also have access to a range of subsidised medicines through the Pharmaceutical Benefit Scheme (PBS). Nonetheless, there is room for improvement if we want better outcomes delivered more efficiently.

Australia's health arrangements are complex. It is a web of government and non-government funders and service providers acting across the different but inter-related sectors. The operation of each sector can affect other parts of the system.

Currently, Australians' experience of health care varies. The majority of Australians, who require one-off care for the flu or a broken arm or even complex surgery, are treated well and relatively quickly. Increasingly though, Australia's 'burden of disease'²⁵ is shifting from one-off illness to ongoing chronic health conditions, like cancer, heart disease, and mental illness.

The health system does not work as well as it could for those with complex and chronic health conditions who are frequent users of health services, for those in regional and rural areas, and for Indigenous Australians. The high prevalence of chronic disease amongst Indigenous Australians contributes significantly to the gap in life expectancy between Indigenous and non-Indigenous Australians.

The system is also coming under increasing pressure from rising costs. The nation faces difficult choices about how these rising costs are to be met into the future. Governments already spend a lot on health care. In 2012-13, total expenditure on health care in Australia was more than \$147 billion, with total government expenditure more than \$100 billion.²⁶

The Commonwealth provides the majority of government health funding (\$61 billion), but the States and Territories also provide a significant amount (\$39.8 billion). The remaining funding (\$46.4 billion)

²³ Australian Institute of Health and Welfare, *Australia's Health 2014: in brief*, Canberra, 2014, p.2

²⁴ Using OECD System of Health Accounts framework, 2012-13 Health expenditure in Australia was 9.4 per cent of GDP, against the OECD median of 9.2 per cent. Australian Institute of Health and Welfare, *Health Expenditure Australia 2012-13*, Canberra, 2014, p. 30

²⁵ 'Burden of disease' is the number of healthy years of life lost due to illness or death—see Australian Institute of Health and Welfare, *Australia's health 2014*, AIHW, 2014, Canberra, p. 90

²⁶ Australian Institute of Health and Welfare, *Health Expenditure Australia 2012-13*, AIHW, 2014, Canberra, p. 35

is provided by private health insurers, other third party insurers and individuals, through direct out-of-pocket payments.

Health has been a major contributor to recent growth in government expenditure.²⁷ The Grattan Institute has estimated that if the cost of health services continues to increase at recent rates, total government health expenditure is predicted to increase by as much as 2 per cent of GDP by 2023.²⁸ This could take Australia's health spending from the current 9.4 per cent²⁹ (around the current OECD average of 9.2 per cent) to over 11 per cent of GDP.

The majority of State and Territory health funding is on public hospitals. In 2012-13, over two thirds (around \$23.7 billion) of their health budgets went to public hospitals.³⁰ This is also the biggest area of shared funding between the Commonwealth and the States and Territories—governments spent \$43.9 billion on public hospitals in 2012-13, over 31.6 per cent of total recurrent (non-capital) government health expenditure.

The States and Territories provided almost 54 per cent of funding for public hospitals in 2012-13, with the Commonwealth providing 37 per cent.³¹ The balance was provided by individuals (3 per cent), private health insurers (2 per cent) and other sources (including workers' compensation and motor vehicle insurers, totalling 4 per cent).

In contrast, the biggest area of Commonwealth health funding is on its own health programmes, like the Medicare Benefits Schedule³² (MBS) and the PBS. In 2012-13, 59.2 per cent (or \$36.1 billion) of Commonwealth health funding was on its own programmes.³³ Figure 4.1 below shows who funds what in Australia's health system.

²⁷ J Daley, C McGannon, and A Hunter, *Budget pressures on Australian Governments: 2014 edition*, Grattan Institute, Melbourne, 2014, p. 17

²⁸ Daley, McGannon, and Hunter, p. 20

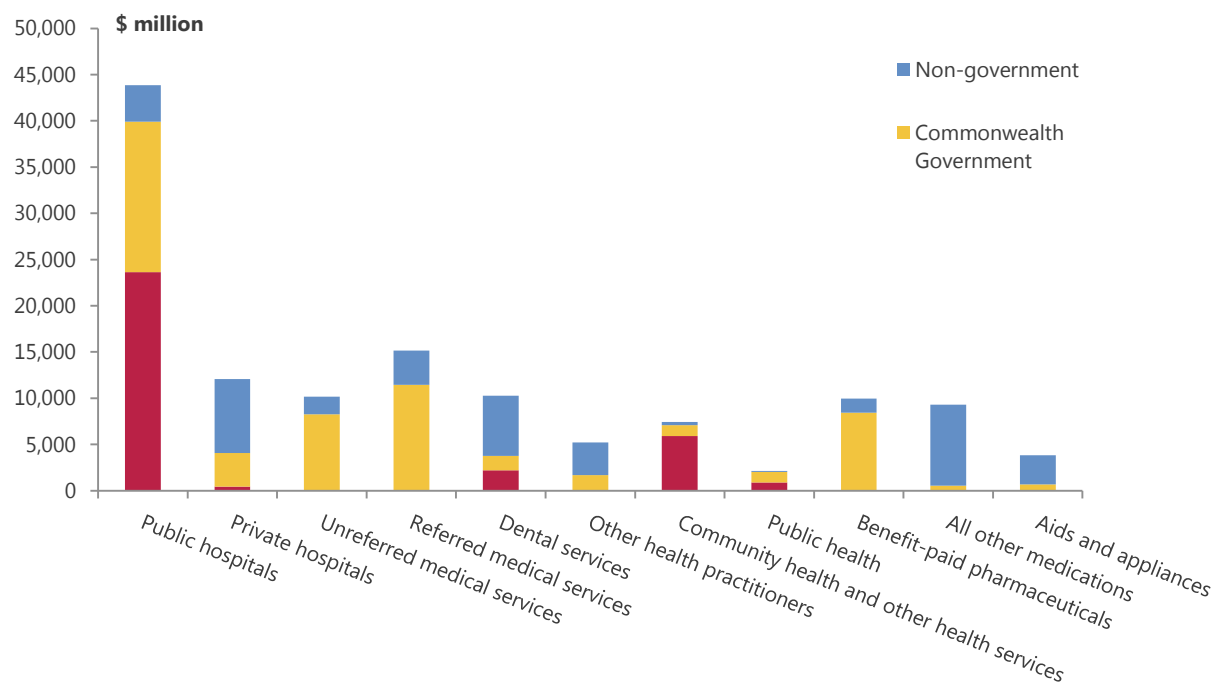
²⁹ According to the Australian Institute of Health and Welfare, Australia's health expenditure to GDP ratio was 9.4 per cent in 2012.

³⁰ Australian Institute of Health and Welfare, *Health Expenditure Australia 2012-13*, p. 46

³¹ Australian Institute of Health and Welfare, *Health Expenditure Australia 2012-13*, pp. 38-39

³² The Medicare Benefits Schedule is the list of health services subsidised by the Commonwealth.

³³ Australian Institute of Health and Welfare, *Health Expenditure Australia 2012-13*, p. 43

Figure 4.1: Area of health expenditure 2012-13

Source: Australian Institute of Health and Welfare, *Health Expenditure Australia 2012-13*, AIHW, 2014, Canberra, p.38

Although large amounts of money are spent by governments on hospitals, primary care, and other clinical care, there is more to Australia's health system than GPs and public hospitals.

Preventive health and public health programmes are an important part of health care, though by comparison attract a small proportion of total health funding (around 1.5 per cent). Preventive health activities include health promotion, food safety and immunisation, and are funded and delivered by both the Commonwealth and the States and Territories.

Aboriginal Community Controlled Health Organisations (ACCHOs) are another critical part of the health system. ACCHOs are funded by the Commonwealth (through a mix of MBS and block grant funding) to deliver comprehensive and culturally appropriate health services to their communities. Indigenous Australians can also access mainstream health services. As such, it is important these services are provided in a culturally appropriate way.

Private health insurance is also a fundamental pillar of the Australian health system. Individuals can take out health insurance to cover the costs of care as a private patient in public or private hospitals and for services provided by dentists and a range of allied health professionals.

Individuals make decisions and take actions to manage their own health and health care. They also make a significant contribution to funding their own health care costs, largely through out-of-pocket expenses and the purchase of private health insurance.

The focus of this section of the Green Paper is on the divide between the various clinical parts of the health system—hospitals, primary care, and other clinical care. This is not to downplay the importance of the rest of the health system, or to disregard the fact that all the parts of the health system are linked. It is simply a matter of focusing efforts on the largest areas where the structure of the Federation is getting in the way of delivering health services.³⁴

Pressures on the health system

The pressures on the health system are driven by a number of factors, not all of which relate to the Federation. For example, health costs are rising because of technological change leading to improved treatment (but more expensive facilities and equipment), higher demand for health services, and an ageing population.

Demand for health care is projected to increase.³⁵ Cost pressures will also increase as the number of Australians living with one or more chronic conditions rises. As much as 35 per cent of the population reports having at least one chronic condition, with the proportion increasing with age.³⁶

Chronic conditions are expensive to treat. In 2008–09, almost \$20 billion was spent by government and non-government sources treating three of the most expensive chronic conditions (cardiovascular disease, mental health conditions, and musculoskeletal conditions).³⁷

A lot of health funding is spent on a small proportion of the population. In 2012–13, just ten per cent of patients accounted for around 45 per cent of MBS expenditure and around 60 per cent of PBS expenditure.³⁸

Information from private health insurers paints a similar picture—it is the frequent users of the health system who cost the most to treat. According to Medibank Private’s data, 3 per cent of its members account for almost 35 per cent of all their hospital and medical costs. Most of those members had a chronic condition.³⁹

³⁴ The Federation White Paper issues paper, *Roles and Responsibilities in Health*, paints a fuller picture of the different parts of the health system.

³⁵ Productivity Commission, *Efficiency in Health*, Commission Research Paper, Canberra, 2015, p. 7

³⁶ AIHW, *Australia’s health 2012*, Australia’s health series no.13 Cat. no. AUS 156 Canberra, 2012, p. 354

³⁷ AIHW, *Australia’s health 2014*, p. 96

³⁸ Minister for Health, the Hon Peter Dutton MP, Address to Committee for Economic Development of Australia, 19 February 2014.

³⁹ G. Savvides, *How productive is Australia’s healthcare system?*, Presentation to the Committee for Economic Development of Australia, March 2015, viewed April 2015 <<https://www.medibank.com.au/content/about/media-centre/2015/03/medibank-md-george.html>>.

Over time, community expectations that governments will continue to meet the rising cost of high quality health care have grown. These expectations may no longer be realistic in a period of constrained government revenue.

All governments want better health for all Australians and a health system that delivers high quality and cost effective care.

A better health system would improve incentives for health care providers to focus on prevention and early intervention, assisting people to manage their health effectively. Payments based on improvements in people's health provide clear incentives to reduce costs associated with waste, mistakes and inappropriate care settings. This would include managing chronic conditions before they worsen and require further treatment. More health services would be provided in the community rather than in hospitals.

Specifically this requires a health system:

- centred on the patient's health and well-being;
- that is safe, provides the right care, in the right setting, at the right time, and supports prevention and early intervention;
- where consumers are empowered to manage their health and health risks, and to make health care decisions;
- that is fair and supports disadvantaged and vulnerable people and communities;
- that operates effectively, delivers value for money, and eliminates waste;
- with flexibility for innovation, adaptable to meet local circumstances, and encourages continuous improvements in services;
- anticipates and responds to the needs of an ageing population;
- that measures success and aligns incentives with people's health and wellbeing; and
- supported by clear roles and responsibilities so the public can hold governments to account.

The health system within the Federation

To what extent, though, can the pressures on the health system be addressed through improving the way the Federation operates?

Stakeholders commented that the health system is not patient-focused.

It is reactive and revolves around episodic care and the treatment of illness, rather than trying to support prevention and early intervention.

Stakeholders also said current funding arrangements and financial incentives are structured around providers rather than health outcomes—funding is provided on the basis of activity, rather than on improvements in people's health.

The Productivity Commission has noted that the financial incentives for health care providers “should promote clinically and cost effective health interventions, but to achieve this in practice is difficult”.⁴⁰ It also noted that while no payment model was perfect, the fee-for-service payment method (the dominant method used to fund primary care) had raised concerns about “over servicing, reduced quality and safety standards, fragmented care, and cost-shifting”.

The fragmented and complex web of government roles in different parts of the health system also makes enduring or meaningful structural change difficult to achieve. The health system is an example of a shared space where the way governments work together has not been co-designed from first principles—the different government roles are more the result of history rather than any formal decision about who should be doing what.

The Commonwealth and the States and Territories are separately responsible for funding the two largest parts of the system:

- the Commonwealth is mostly responsible for subsidising primary care and other clinical care (although the States and Territories provide community care); and
- the States and Territories are mostly responsible for funding public hospitals (although the Commonwealth provides a funding contribution).

The States and Territories are system managers of public hospitals and also deliver community health services. Other services are delivered by private providers, such as GPs, specialists, allied health professionals, and private hospitals. The Commonwealth is not directly involved in providing clinical health services.

The policy and regulation roles are largely shared between the Commonwealth and the States and Territories, and the training and regulation of the health workforce is also shared.

Efforts to coordinate action on national priorities have been made through multi-jurisdictional bodies, like the COAG Health Council and the Australian Health Ministers’ Advisory Council. Despite this, governments can, and often do, make decisions without proper consideration of the flow-on effects on other levels of government.

For example, when primary care is not working well, the States and Territories bear the costs through their public hospital systems. On the other side of the coin, in the past some public hospitals have encouraged patients to elect to be treated as private patients, meaning the Commonwealth and private insurance picks up more of the costs.

There is also a strong interaction between the health system and other areas of social policy. In aged care, there can be instances of unnecessary and unplanned transfers from aged care facilities to hospitals, while areas like mental health have a strong connection with housing and homelessness,

⁴⁰ Productivity Commission, *Efficiency in Health*, Commission Research Paper, Canberra, 2015, p. 2

disability, education, and employment services. Clearer accountabilities within the health system would help to manage these interactions.

The fragmentation within the system affects patients in a real way.

In 2009, the National Health and Hospitals Reform Commission found fragmentation leads to uneven access to services and quality of care for patients.⁴¹ The Commission also made it clear patients are the ultimate losers from the 'blame game' as they end up waiting longer for care, or cannot access the services they need.⁴²

Stakeholders expressed frustration that Commonwealth and State and Territory involvement in similar areas is usually poorly coordinated. The result is duplicated effort, wasted taxes, and poorly targeted programmes—especially in areas like mental health and drug and alcohol support.

This lack of coordination also makes it hard for patients with chronic and complex conditions to get the care they need, when they need it. This is particularly evident in areas like mental health, where patients are required to navigate an overly complicated system.

Poorly coordinated action can also increase costs. In 2012-13, there were over 400,000 potentially preventable admissions to public and private hospitals for chronic conditions.⁴³ With the right early intervention and care, many people could avoid expensive hospital admissions, leading to improved health.

Poor data collection and sharing

Government intervention in health care can be misdirected or ill-informed when information is not shared between the Commonwealth and the States and Territories.

Without access to comprehensive data across the overall system, governments tend to focus on their areas of responsibility, rather than considering what might be best for the system as a whole. The lack of data in areas of the health system (other than for hospital services) also means that painting a picture of a patient's pathway through all health services they receive is not possible.

Recent collaborative work between the Commonwealth and the States and Territories has resolved some issues around States and Territories accessing Commonwealth data (for example, MBS and PBS data). Ongoing collaboration will lead to better and more strategic use of this data.

A fully functional e-health system will also help, however, more needs to be done.

⁴¹ National Health and Hospitals Reform Commission, *A Healthier Future for All Australians: final report*, Canberra, 2009, pp. 56-57.

⁴² National Health and Hospitals Reform Commission, *Beyond the Blame Game: Accountability and performance benchmarks for the next Australian Health Care Agreements*, Canberra, 2008, p.20

⁴³ AIHW, *Australian hospital statistics 2012-13*, AIHW, Canberra, 2014, p.116

The division of roles between the Commonwealth and the States and Territories has led to accountability for discharging financial responsibilities becoming a greater focus than accountability for improving people's health.

Governments and providers direct significant energy towards demonstrating how funds are spent (often referred to as 'input controls' or 'conditions on funding'), rather than measuring results. This is discussed further in *Chapter 3: Governance and accountability*.

It leads to 'blame shifting', where each level of government suggests any funding gaps should be met by the other, in an unproductive debate citizens find frustrating.

How reform of the Federation can help achieve a better health system: options for reform

Federation reform is focused on whether the allocation of roles between the Commonwealth and the States and Territories could be better designed to improve the health system.

A fundamental challenge where the Federation plays an important role is overcoming the barriers between primary and hospital care to improve people's health and the efficiency of the system, and to reduce cost-shifting between governments. Another important challenge is establishing durable funding models.

As mentioned earlier, the health system has never been co-designed by all relevant parties to ensure the entire system is working as well as it could to deliver the health services that Australians need. Ensuring there is an environment where all governments can work together as well as possible is critical in an area like health, where there is likely to always be an element of shared space. Chapter 3 proposes reform options that could create this environment.

Some of the reform options could see either the Commonwealth or the States and Territories take on additional roles and responsibilities which would have significant financial implications. Where this is the case, the reform options set out in *Chapter 5: Federal financial relations* would need to be considered such that each level of government has sufficient revenue to discharge their expenditure responsibilities.

All options would require careful planning, management, and transition periods to limit disruption to the sector during implementation.

Some options could be introduced early as a way of building up to more systemic and longer-term reform.

Five reform options are presented for consideration below, drawing on discussions at the stakeholder roundtables and consultation with the States and Territories and the Prime Minister's Expert Advisory Panel. *Chapter 2: Improving Australia's Federation* discusses how the reform options were developed.

Another option considered through this process, but not formally put forward, has also been described briefly at the end of this section.

When considering which option is best, the criteria that need to be borne in mind are those that have been agreed by COAG, namely, will the option: improve the delivery of better services, promote fairness, contribute to economic growth, clarify responsibilities, and be durable?

Critical to delivering on all these criteria will be a focus on reducing future costs of delivering quality care through effective use of technology, more efficient use of highly skilled professionals, e-health, prevention and early intervention, and better chronic disease management.

When thinking about the financial implications of these options for governments, it is important to consider the big picture.

Rather than focusing on what each level of government spends currently, the question that should be front of mind is how the (approximately) \$100 billion that both levels of government are currently spending should be spent if we want to improve Australians' health.

The question of which level of government is responsible for what proportion of that global budget follows from the answer to that initial question.

The options presented focus on the two largest parts of the health system—primary and specialist care and public hospital services. Reforms to other areas, such as research and the health workforce, could be considered by governments separately, or as complementary parts to implementation of other options.

For ease of presentation, these options are set out individually. This does not mean they are mutually exclusive. Aspects of some options could work well in parallel, or in combination, with other options. Such consideration would guard against only focusing on distinct parts of the health system, rather than considering the system as a whole.

The order in which the options appear does not indicate any preference.

Option 1: The States and Territories fully responsible for public hospitals

Under this option, the States and Territories would have full policy, funding, regulatory, and service delivery responsibility for public hospitals.

The States and Territories would be free to make decisions about the level of investment in, and delivery of, public hospital services and would have the flexibility to commission services through the private sector.

The Commonwealth would no longer provide funding for public hospital services and would have no role in setting operational targets for public hospitals. The Commonwealth would continue to be involved in high level health policy and the subsidisation of private health insurance.

Other health care roles, including primary and specialist care and private hospitals, would be unchanged.

Under this option, the removal of Commonwealth involvement in setting operational targets, such as waiting times in emergency departments, would improve flexibility for the States and Territories to develop local solutions for local problems, without additional conditions on how funding is spent. This is consistent with the principle of subsidiarity.

This option delivers clearer lines of accountability. Australians would know who to hold to account for the provision of better hospital services.

Consolidating and allocating funding responsibility to one level of government would sharpen incentives for delivering cost effective public hospital services, but would not give the States and Territories control over broader system levers (such as primary and aged care) which contribute to public hospital costs.

This option may therefore need to be complemented by other reforms to provide incentives for greater efficiency, effectiveness and connectedness of service delivery between the different parts of the health care system. An effectively functioning and widely-used e-health system may go some way to supporting this.

Without these other complementary reforms, this option risks entrenching the existing incentives for governments to shift costs (and blame) to other parts of the system. It also does not, on its own, improve access to primary and specialist care or address the fragmentation between public hospitals, primary care and other health care providers.

Structures would need to be in place to ensure effective planning and coordination of patient care across the health system, for example, when moving between hospitals and aged care, primary care, or disability support, following discharge from a hospital.

The ongoing financial durability of this option is likely to be challenged if the level of avoidable hospital admissions cannot be reduced, or if failures in the primary care system lead to public hospitals picking up the slack. Durability will also be challenged if the States and Territories do not have access to adequate revenue.

Option 2: The Commonwealth establishes a hospital benefit

The Commonwealth would establish a hospital benefit for all hospital treatments and procedures, regardless of whether they are performed in a public or private setting or whether individuals elect to be treated as private or public patients. Similar to the operation of the MBS, funding would follow individuals. The Commonwealth would fund a proportion of the cost of each procedure, with the price determined by an independent body.

The States and Territories would be asked to cover the difference between the Commonwealth benefit and the cost of the service for public patients to ensure they continue to receive free treatment in a public hospital in line with the Medicare principles and international agreements. This would be the public hospital equivalent of bulk-billing in general practice. People choosing to be treated as private patients could take out private health insurance to cover the difference, or choose to pay the gap themselves.

The States and Territories would remain system managers of public hospitals and would be free to make decisions about the delivery of public hospital services and would have the flexibility to commission services from the private sector. They would continue to be responsible for the regulation and delivery of public hospital services. The Commonwealth would have no role in setting operational targets for public hospitals.

The Commonwealth hospital benefit would replace current Commonwealth funding for public hospitals through transfers to the States and Territories and for private in-hospital procedures through the MBS. The private health insurance rebate would be discontinued and funding redirected to the new hospital benefit. Funding for other services would remain the same.

A Commonwealth hospital benefit would increase consumer choice for patients and competition for hospital services, where there are sufficient markets and alternative viable providers of hospital services. Increased competition should drive down costs and improve efficiency, and could lead to reduced waiting times for hospital services. As it would reward activity, rather than outcomes, the risk of over-servicing would need to be addressed in implementation.

This option does not address the fragmentation between primary and specialist care and hospital services, and does not provide an incentive for prevention and early intervention. Additional reforms to support connections between different elements of the health system may need to be considered.

This option could reduce incentives for cost-shifting between the Commonwealth and the States and Territories by aligning funding between public and private settings. The Commonwealth's contribution to the funding of hospital services would remain the same, but would be more transparently and directly linked to the cost of procedures.

The option is likely to improve the durability of hospital funding. Alternative mechanisms (for example, block funding) would be required to address thin or non-existent markets (for example, in regional and remote areas). The impact on the private health insurance market would also need to be considered, including the impact on consumers through changes to premiums.

This option improves the accountability and fairness of funding of hospital services. It would be consistent with other Commonwealth benefit payments to individuals.

Option 3: The Commonwealth and the States and Territories jointly responsible for funding individualised care packages for patients with, or at risk of developing, chronic or complex conditions

The Commonwealth and the States and Territories would jointly fund individualised care packages for people with, or at risk of developing, chronic or complex conditions. These individuals could be identified based on referrals from GPs and other clinicians.

Funding would be provided for all services received by the patients, including GP visits, specialist appointments, hospital care, and care from allied health professionals. Individualised packages would be flexible and could be tailored to the individual's particular condition and treatment needs.

The option could be implemented in a number of ways and incorporate flexibility in design to suit local needs. The number of people included could be increased over time.

A 'light touch' approach to individualised care packages could involve additional administrative support for patients and better links with other service providers, including helping patients schedule and manage appointments, and following up on referrals and medication regimes.

A more comprehensive approach to individualised care packages could involve patients registering with a care provider and having a care plan developed by a GP or other clinician. A care plan would include treatment from a range of service providers. The care coordinator (not necessarily a clinician) would purchase and manage all aspects of the individual's health care, including follow-up and reminders.

A method of 'blended payments' could be used to fund care coordinators to purchase services. This could involve a blend of fee-for-service and risk-weighted capitation payments from the joint funding pool to the care coordinator for their registered population. This would provide the coordinators with financial incentives to purchase the most cost effective treatment for their clients.

This option would need to be supported by an information sharing platform, such as e-health. The remainder of the health system would be unchanged.

The Commonwealth and States and Territories would jointly agree the amount of health funding to be redirected to fund individualised care packages.

This option creates additional shared roles for the policy and funding of coordinated care services. Well-designed shared governance arrangements and funding for coordinated care should reduce incentives for cost shifting and improve incentives for investing in prevention and early intervention.

This option addresses the divide between hospital services, primary care, and other clinical providers, and puts the patients who use health care the most (around 1 to 2 per cent of hospital patients) at the centre of the health system, providing them with better services. Australians with, or at risk of developing, complex and chronic conditions should experience improved health and quality of life.

It should reduce avoidable hospital admissions and presentations to emergency departments. It provides financial incentives for care coordinators to ensure patients with, or at risk of developing, complex and chronic conditions are receiving the right care across the spectrum of health services, including mental health, allied health and specialist services.

This option would not change services for the majority of the population. It would also not immediately address issues of fragmentation more broadly, or disjointed government policies in other parts of the health system.

This option, and various sub-options, could be trialled on a small scale before rolling-out more broadly. The scale could be increased as part of more ambitious reform options, such as the Regional Purchasing Agencies (Option 4) described below.

Option 4: The Commonwealth and the States and Territories share responsibility for all health care through Regional Purchasing Agencies

The Commonwealth and the States and Territories would jointly establish regional purchasing agencies. These agencies would purchase a range of health services for individuals in their catchment, defined by a minimum service obligation including primary and specialist care, hospital (both public and private), and allied health services. Agencies could be accountable to the Commonwealth and the State and Territories, or just one level of government.

The Commonwealth and the States and Territories would pool funding to make payments to the purchasing agencies based on demographic and health characteristics of catchment populations and the mix of services covered by the minimum service obligation. Agencies would then be responsible for managing the purchase of health services from within this fixed budget.

Catchments for regional purchasing agencies could be based on existing structures, such as Primary Health Networks and Local Hospital Networks, or their equivalent State or Territory health service authorities.

High level health policy, including setting minimum standards of care and quality, and funding roles would be shared between the Commonwealth and the States and Territories. Regional purchasing agencies would be responsible for funding and commissioning primary care and the MBS would no longer operate in the same way—for example, it could be cashed out to help fund the regional purchasing agencies. The impact on other roles would need to be considered.

Various options could be considered for the establishment of regional purchasing agencies. They could be government or semi-autonomous government bodies, they could be managed by private organisations, selected through a competitive tender process, or there could be a mixture of different approaches. One option would be for the role of the Commonwealth to be limited to funding and setting minimum standards of care and quality, with the States and Territories taking responsibility for governance and system management.

The Commonwealth and the States and Territories would agree to jointly fund regional purchasing agencies from existing health funding.

This option would increase areas of shared responsibility between the Commonwealth and the States and Territories. It could seek to build on existing governance arrangements.

Responsibility for service delivery and the commissioning of services would lie with the purchasing agencies. This would allow for greater competition in the market for services.

This option would address system fragmentation and may also better respond to local circumstances. This is consistent with the principle of subsidiarity and should result in better services for patients, so long as adequate arrangements are in place to ensure provision of quality services in remote and disadvantaged regions.

Pooled funding arrangements would need to be established in a way that would reduce incentives for cost shifting between governments. This approach should also increase incentives for investment in prevention and early intervention. There would be an incentive to ensure services were provided cost-effectively within allocated funding to avoid unnecessary (and costly) hospitalisations.

This option would include many of the benefits of individualised care packages (Option 3 above). It would need to be supported by well-designed and clearly defined roles to minimise the risk of blurred accountability and blame-shifting, resulting in service gaps.

This option involves large-scale reform. It would present particular challenges for rural and remote areas where there are fewer existing services. Consideration would need to be given to the size of purchasing agency regions, to ensure they cover a large enough population to manage risk, realise economies of scale, and ensure availability of suitably skilled staff. This could be an issue for smaller States and Territories.

Consideration would also need to be given to the role of private health insurers.

Once implemented, this option would be durable as the health system would contain incentives to provide people with the care they need in a cost-effective manner as agencies operate from a fixed budget. It would take some time to implement and would require a significant up-front investment, in addition to ongoing operational costs.

Option 5: The Commonwealth establishes a health purchasing agency

The Commonwealth would establish a purchasing agency to commission a range of services, including primary and acute care, from public and private providers, based on the requirements of each community. This would include purchasing public hospital services from the States and Territories. Purchasing would use competitive processes where possible and fund services on a provider neutral basis.

The Commonwealth would assume high-level health policy responsibility and regulation of providers. The Commonwealth would become the single government funder of health services and funding transfers to the States and Territories for health services would cease.

States and Territories could continue to operate services, including public hospitals and community health services, which would compete for contracts with other public and private providers. States and Territories would be free to structure the ownership and operation of services as they see fit.

Under this option, the Commonwealth would fund the purchasing agency, which would then purchase services from government or private providers. This may affect the viability of some services in some areas.

This option should increase competition between providers, drive down costs, and improve efficiency. There would be challenges in smaller jurisdictions and regional areas where there is a limited market to support competition. Efficiencies may still be possible for highly specialised services or locations with little competition through competitive tender processes, provided safety and quality requirements are specified and enforced.

The agency would have a full picture of all government funded health services. Consolidating funding responsibility with one level of government would sharpen incentives to provide services in a cost effective manner. This should reduce the amount of fragmentation in the system, remove the potential for cost and blame shifting and provide an incentive for investment in prevention and early intervention.

Access to consolidated data should help increase transparency around funding and ensure that health services are delivered efficiently and effectively.

This option could reduce the ability to flexibly respond to emerging local requirements across the country. This issue could be addressed by using existing local structures, such as Local Hospital Networks, Primary Health Networks, or equivalent State or Territory health service authorities, to implement tailored responses to local needs.

The agency would be required to negotiate contracts with a very large number of providers, some of whom may be monopoly providers for some services or in certain areas.

This option involves significant reform to the health system—including the roles of governments and public and private health care providers. Consideration would need to be given as to how the MBS, PBS, and other programmes operate.

A variation on this option would be to set up a 'single funder' in any State or Territory that was willing to strike an agreement with the Commonwealth to do so. The single funder would be responsible for funding, planning, and integrating all health services in that State or Territory. Consistent with an agreed plan, the single funder would contract for health services from existing public and private providers. This variation would need to be supported by well-designed and clearly defined roles to minimise the risk of blurred accountability.

Other reform options we considered

Some stakeholders at the roundtables called for more wholesale, structural reform of the health system. One of the options put forward was introducing a type of managed health care market, as recommended by the National Health and Hospitals Reform Commission in 2009.

Under this option, all Australians could elect to enrol in a health care plan of their choice, or decide to stay with Medicare as the 'default' health care plan. The Commonwealth would raise revenue through taxation and distribute funds to plans based on a risk-adjusted profile for their customers.

All health care plans would be required to meet the universal coverage of Medicare (in relation to services offered) for their customers, at no out-of-pocket cost to the customer. Health care plans could also offer additional services on top of the basic care requirements, with customers meeting the additional costs of those extra services.

Individuals would be free to change plans. Health plans would have no right of refusal to provide coverage and coverage would be mandated. This would allow for competition between plans based on price and the type of services offered.

The health plans would purchase health services for their members, with individual contributions potentially required for some services beyond the universal entitlement. This would separate responsibility for funding or purchasing and service provision.

Converting Australia's health system to this model would involve significant structural reform. The implementation period would be long and transition costs significant. The success of the model would also rely on a market being established with various competing health plan providers offering health care plans, thus driving down costs.

These factors, along with the general view that Australia's health system works well for most people at the moment, led to this reform option not being put forward for consideration as part of the Reform of the Federation process.

4.2 Education

How Australia's education system is performing now

Education—from early childhood education to higher education—is a life-long process.

At its most fundamental level, it is about the knowledge, skills, and qualifications people need to fully participate in their community and society. It also brings benefits to our economy.

For individuals, a high quality education can lead to better employment prospects and future earning capacity. For the economy, a highly-skilled labour force is vital to improving our productivity and prosperity and safeguarding our international competitiveness.⁴⁴

Australia's education system is world-class.

It is a result of significant effort and investment from all levels of government over many years but it continues to face funding pressure.

Government investment across all areas of education has increased sharply in recent years. In the decade to 2013-14, governments' spending on education grew by around 1.5 times the rate of inflation.⁴⁵

This increase was driven by a number of factors, including increasing enrolments, more students staying and finishing school, and increases in the costs of core educational delivery, including things like smaller class sizes.⁴⁶

Spending on education now makes up 13 per cent of all spending by Australian governments and schooling is the third biggest area of spending by all Australian governments (the Age Pension and public hospitals being the largest), comprising 8 per cent of GDP.

Despite this investment, the outcomes for children, students and learners do not appear to have improved. In fact, as set out below, by international standards our schooling outcomes are declining. The outcomes for Indigenous students, in particular those living in remote areas, are especially poor and have demonstrated little or no improvement over the last decade.

As a result, governments' funding needs to be used better in order to improve our education system.

⁴⁴ Commonwealth of Australia, 2015 Intergenerational Report, Canberra 2015 indicates that economic growth into the future will come from productivity which is directly linked to education.

⁴⁵ Calculated using the Australian Bureau of Statistics inflation calculator:

<www.abs.gov.au/websitedbs/d3310114.nsf/home/Consumer+Price+Index+Inflation+Calculator>.

⁴⁶ J Daley and C McGannon, *Grattan Institute paper: Budget pressures on Australian governments*, Grattan Institute, Melbourne, 2013.

Specifically, all governments want:

- an **early childhood** sector that is high quality, affordable, accessible, easy to navigate and supports children to meet developmental goals, prepares them well for school and beyond, and enables the workforce participation of their parents and families;
- a **schooling** sector that enables all children to meet their full potential regardless of where they live, or which education setting they attend, provides students with the knowledge and skills to flourish in life and work, and sets up a clear pathway into training, work or further education;
- a **vocational education and training (VET)** sector that equips learners with the skills and attributes to participate in social and economic life, and supports Australia's long-term productivity and competitiveness by meeting employers' current and emerging workforce needs; and
- a **higher education** sector that provides a clear pathway into further education or work, has strong relationships with industry, and with world-class teaching and research that drives innovation and productivity and helps assure Australia's economic future.

Realising these visions is likely to require a shift from the traditional approaches usually adopted by governments, and we need to consider through this process how the roles and responsibilities within the Federation can work to support this.

The Commonwealth does not have specific constitutional responsibility for the provision of education, but has increased its involvement in education over time. This is most apparent in the child care and early learning and schooling sectors, where the Commonwealth now plays a key role in setting national policy and providing funding.

Similarly, the arrangements between the Commonwealth and the States and Territories across policy, funding, and regulation in the VET sector have also seen the Commonwealth's involvement increase. The sector where the division of roles and responsibilities is most clear is the higher education sector, where the Commonwealth is clearly recognised and understood to be the major player.

The current arrangements have undoubtedly blurred the lines of accountability to the general public. As a result, it's not always clear who ultimately is responsible for the delivery of high quality services.

On the other hand, the involvement of the Commonwealth has led to important developments that have increased the performance of the education system.

This process offers the opportunity to re-affirm where shared responsibilities between levels of government are working well, and identify areas within the current allocation of roles and responsibilities in early childhood, schooling, VET, and higher education that could be improved to ensure Australians are receiving the best education services they can.

Chapter 3: Governance and accountability proposes reform options that could create an environment to ensure all governments can work together as well as possible in areas of shared space in education. A number of the reform options and their mechanisms proposed in this Chapter could be a

consequence of some of the proposed governance and accountability reforms, for example, the reform option in VET on a new agreed national framework for sharing and coordinating roles (Option 3).

When considering the best reform options in each sector, the criteria that need to be borne in mind are those that have been agreed by COAG, namely will the option: improve the delivery of better services, promote fairness, contribute to economic growth, clarify responsibilities, and be durable?

Chapter 2: Improving Australia's Federation discusses how the reform options were developed.

Some of the reform options could see either the Commonwealth or the States and Territories take on additional roles and responsibilities which would have significant financial implications. Where this is the case, the reform options set out in *Chapter 5: Federal financial relations* would need to be considered such that each level of government has sufficient revenue to discharge their expenditure responsibilities.

All the reform options in each sector would require careful planning, management, and transition periods, to limit disruption to the sector during implementation. Some could be introduced early as a way of building up to more systemic and longer-term reforms.

4.2.1 Child care and early learning

How Australia's child care and early learning sector is performing now

Australia has a high quality child care and early learning sector, and most children participate in some form of early learning before commencing formal schooling.

Apart from the significant education benefits it brings children, child care also plays a critical role in promoting workforce participation by helping parents balance their commitments to work and family.

Efforts to more closely integrate child care and early learning into a system are relatively recent, and this system has been undergoing significant reform since 2008 with the first National Quality Agenda (NQA) agreed by all governments in 2009.

The NQA aims to lift the quality and consistency of all child care and early learning services through the National Quality Framework (NQF), which introduced a set of minimum quality standards for providers. For example, the standards set minimum educator-to-child ratios and minimum requirements for staff qualifications, and require services to promote healthy eating and physical activity.

In addition to this focus on quality, the system continues to adapt to address the issues of affordability, accessibility and flexibility.

Currently, the Commonwealth is the major funder of the sector, providing over \$6.2 billion in 2013-14.⁴⁷ The bulk of its investment is focused on supporting national workforce participation by helping families meet the cost of child care, currently through Child Care Benefit (CCB) and Child Care Rebate (CCR) payments.

State and Territory spending was around \$1.5 billion in 2013-14,⁴⁸ with around \$1.2 billion spent on preschool provision. The latter includes a Commonwealth contribution of about \$400 million a year under the *National Partnership (NP) Agreement on Universal Access to Early Childhood Education* which ensures children can access 600 hours of preschool education in the year (about 12-15 hours a week) before they attend full-time school. This NP also includes a commitment from all governments that 95 per cent of Indigenous four-year-olds are enrolled in quality early childhood education programmes by 2015.

Despite this focus from all governments, the child care and early learning system can fall short of expectations, and some parents and families still find fees prohibitive.

The Commonwealth has taken some steps in its 2015-16 Budget to address some of these concerns. Its new Families Package will introduce a new Child Care Subsidy (to replace the existing subsidies), as well as a new Child Care Safety Net to provide targeted assistance to Indigenous, vulnerable and disadvantaged children and communities. It also includes \$246 million for a two-year Nanny Pilot Programme and \$843 million to extend the universal access NP until December 2017.⁴⁹

In terms of accessibility and flexibility, some parents have difficulty securing child care to suit their particular circumstances. They are often required to piece together the types of services they are using to arrive at a total child care or early learning experience for their children to enable them to work.

In some cases, this means they have to shuttle their children between services, routinely have to do the dreaded 'double drop-off', and have to engineer their working arrangements around this. This is particularly difficult for those with unpredictable working arrangements, like shift work.

Regional and remote communities can find it particularly tough to access affordable, quality services. The costs of providing these services are higher, the level of disadvantage can be greater, and patchy demand can mean services are insufficient or non-viable.

Additionally, many Indigenous, vulnerable and disadvantaged children, who would benefit most from structured child care and early learning services, are not accessing these services because

⁴⁷ Productivity Commission, Report on Government Services, Volume B: Child care, education and training, Canberra, 2015.

⁴⁸ Productivity Commission, Report on Government Services, Volume B: Child care, education and training, Canberra, 2015.

⁴⁹ Commonwealth Government Department of Social Services, *Child Care Assistance Package*, 10 May 2015, <http://scottmorrison.dss.gov.au/sites/scottmorrison/files/20150510-Child-Care-Assistance.pdf>.

either the services do not exist in their communities, costs are prohibitive, or they are simply not engaged with the system.

The child care and early learning system within the Federation

To what extent, though, are the issues around quality, equity, affordability, accessibility, and flexibility of the child care and early learning system attributable to the way the Federation operates?

To a large extent, arrangements in the sector are the result of a combination of different policy objectives of different governments and their historic policy interests—namely the Commonwealth’s interest in child care as a means of assisting workforce participation, and the States and Territories’ interest in the education aspects of early childhood development.

The NQA has been the most serious attempt, to date, by all governments to integrate child care with education, and work together to co-design the system.

Perhaps, though, this type of co-design has not yet gone far enough.

As the Productivity Commission noted in its 2014 report, *Child Care and Early Childhood Learning*, whether preschool is the responsibility of the Commonwealth or the States and Territories needs to be resolved as there is still tension between child care and preschools.⁵⁰

This is particularly the case in the way in which preschool services are funded and regulated by the different levels of government.

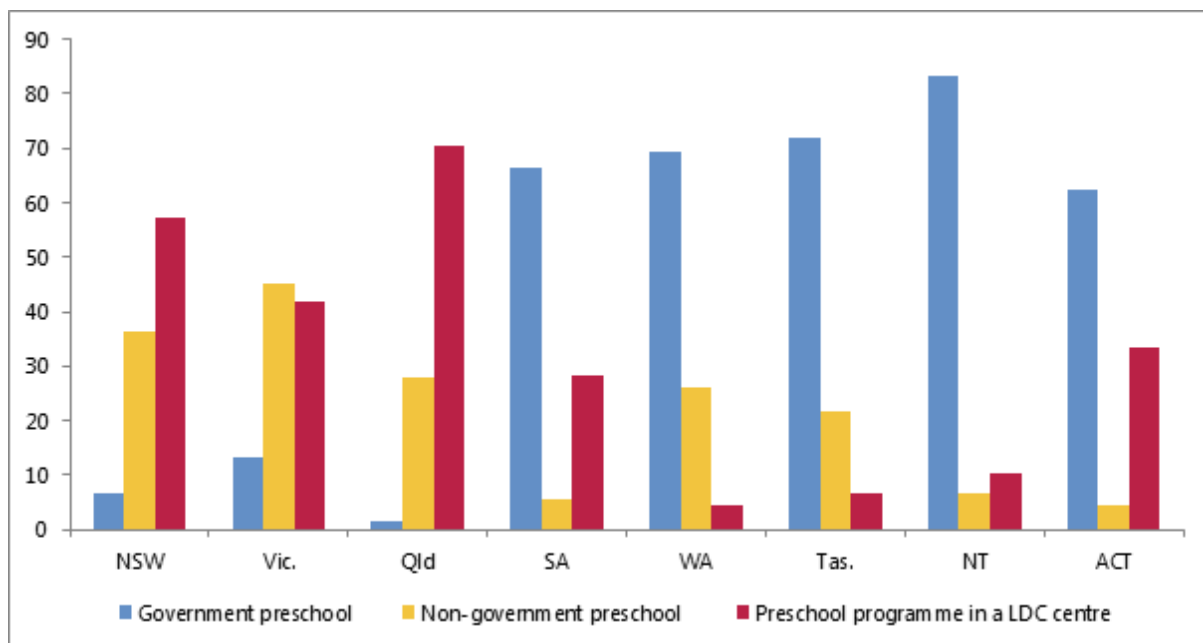
Preschool is delivered by a mix of commercial, government (including local government), and community providers across jurisdictions.

In Western Australia, Tasmania, the Northern Territory, and the Australian Capital Territory preschool is largely embedded in the school system—it is considered to be the first year of the formal schooling system, but is not compulsory. In South Australia, preschool is predominantly provided by government but is not embedded in the school system.

In New South Wales, Victoria, and Queensland, private providers play a bigger role, such as long day care (LDC) centres that offer a preschool programme. Figure 4.2 below shows the differences between the States and Territories.

⁵⁰ Productivity Commission, *Child Care and Early Childhood Learning*, Inquiry Report, Canberra, 2014, p. 497.

Figure 4.2 – Preschool enrolments by service type, jurisdiction (2014)—Per cent of enrolments by State and Territory



Source: Australian Bureau of Statistics, *Preschool Education Australia 2014*, cat. no. 4240.0. Excludes children enrolled in more than one provider type or across multiple preschools.

Different preschool services are funded differently, and the service delivery profile of each State and Territory influences how much Commonwealth funding they receive.

This happens because when a child attends a preschool attached to a government school, the Commonwealth only makes a relatively minor financial contribution, as preschools in government schools are generally funded by the States and Territories on the same basis as schools, and parents are not generally required to pay fees.

Conversely, when a child attends a preschool that is not in a formal school setting, but offered in a LDC setting, it attracts the Commonwealth's fee assistance payments through CCB and CCR.

Another issue with the current funding arrangements for preschools is the lack of durability.

Over recent years, Commonwealth preschool funding for States and Territories has been provided and negotiated through a National Partnership Agreement—which has gone through two iterations and been extended multiple times.

As a result, the preschool funding contribution from the Commonwealth has been uncertain which has made it difficult for States and Territories, service providers, and families to plan.

Stakeholders also said current funding and regulatory arrangements discourage some schools from offering preschool and make it hard for schools to offer child care in conjunction with preschool.

For example, in some jurisdictions schools wanting to offer both preschool and child care have to comply with both the NQF and State or Territory-based education legislation. This particularly affects

jurisdictions where preschool is embedded in the school system (such as Tasmania and Western Australia).

How reform of the Federation can help achieve a better child care and early learning sector: options for reform

While there are issues around quality, affordability, accessibility, and flexibility of child care and early learning services which are in the process of being addressed through a range of governments' responses, stakeholders agree that the current system is functioning reasonably well.

They also argued that any structural reforms considered through this process should not derail or disrupt the benefits of the recent reforms through the NQA and that time was needed to allow them to bed down.

Specifically, this means the following important parts of the sector will continue to operate:

- the NQA;
- the NQF;
- the Australian Children's Education and Care Quality Authority and State and Territory-based regulators; and
- the Australian Early Development Census.

That is not to say, however, that the existing allocation of roles and responsibilities in the Federation needs to be retained in its current form, or with the same balance of effort from all levels of government.

Instead, this opportunity should be used to consider reforms to sort out the funding and regulatory problems, especially with preschools, caused by current Federation arrangements.

Four reform options are presented for consideration below, drawing on the discussions at the stakeholder roundtables, and in close consultation with the States and Territories and the Prime Minister's Expert Advisory Panel.

Another option that was considered through this process, but not formally put forward, has also been described briefly below.

The order in which the options appear in each sector does not indicate any preference.

Option 1: States and Territories fully responsible for the whole sector

States and Territories would be fully responsible for the whole sector.

They would develop policy, regulate service providers, manage service delivery, and exclusively fund both child care and preschool.

Under this option, the Commonwealth would not have any role in the sector and would not make a financial contribution.

Cooperation between jurisdictions would still be possible. For example, the States and Territories could continue to implement the NQF and retain the commitment to universal preschool access.

This option gives State and Territory governments for the opportunity to integrate child care and early learning to support both workforce needs and early childhood learning within their jurisdictions, should they choose to do so.

They would hold all the levers across funding, policy, service delivery and regulation.

It would allow them to integrate these with other areas for which they are responsible—like maternal and child health services—and to manage the transitions between child care, preschool and school. They would be clearly accountable for making sure children are ‘school ready’.

They would have a ‘free hand’ to fund, regulate, and deliver services in a way that meets the specific needs of their jurisdiction.

Parents would know with certainty which level of government to hold to account for the quality, affordability and accessibility of services.

Under this option, States and Territories would fund all service types (for example, LDC, family day care, outside schools hours care, in-home care and any service delivering a preschool programme). They would be able to develop delivery and funding models that align with the priorities they choose to pursue in their jurisdictions. Their responsibility for providing funding durability to parents and services would improve their ability to plan, and share data between services within their jurisdiction.

This option represents a major departure from existing arrangements.

Its implementation would need to be carefully managed over a considerable period of time to assist parents and services transition to any new arrangements and to ensure Indigenous Australians, and vulnerable and disadvantaged groups, are appropriately supported.

It would lead to different arrangements operating across different jurisdictions, and has the potential to jeopardise the benefits and efficiencies of the current national system which promotes workforce participation, as well as early childhood development.

It would also lead to a fragmentation of the policy approach to employment, workforce participation and income support, which are currently mostly the responsibility of the Commonwealth.

This option could also potentially affect some features of the current system that are highly valued by parents and providers, including consistent national quality standards and national child care fee assistance. Child care services that operate across jurisdictions may also encounter increased complexity working with different State and Territory arrangements.

States and Territories would need to administer child care subsidies, either through existing Commonwealth payment infrastructure (which would be complex), or through their existing or newly-developed State-based schemes.

This option would require a significant funding shift to the States and Territories in a policy area of high growth. The existing level of fee assistance is expected to grow to around \$10 billion a year in 2017 under the Commonwealth Government's Child Care Assistance Package.

Option 2: The Commonwealth fully funding all preschools on an equal and consistent basis

The Commonwealth would be fully responsible for funding all preschools—including those delivered by States and Territories in government schools, and by non-government schools, private providers in LDC centres, and stand-alone preschools.

The Commonwealth could provide a funding contribution to either families or providers based on how many children are enrolled in preschools, their needs, and the ability of their families to make a contribution.

The Commonwealth would continue to provide fee assistance for the other forms of child care as it does now.

The other existing arrangements for policy, regulation, and service delivery would continue, but there would be an additional focus on ensuring regulatory arrangements for preschools did not constrain the delivery of services—especially for non-government schools that wish to offer preschool services, and those preschool services that have the capacity to provide outside school hours care.

The States and Territories could provide 'top up' funding for government-run preschools, if they wished to do so.

This option would provide funding certainty by guaranteeing a long-term Commonwealth funding contribution for all preschools, regardless of the setting in which they are delivered.

It could also be a durable arrangement as parents and families would have a very clear and specific expectation about what level of funding their children are entitled to.

As all preschools would be funded by the Commonwealth on the same basis this would ensure funding is equitable across jurisdictions and different service types.

The public would be very clear about which level of government was responsible for funding preschools and the level of the Commonwealth's financial contribution as well as what role the States and Territories have.

The States and Territories would still be responsible for policy, regulation, and service delivery.

Separating responsibility for delivery from responsibility for funding, however, is not always ideal.

Governments have an incentive to ensure services are delivered efficiently when they are also responsible for funding. This incentive can be lost when funding and service delivery roles are separated. It can set up perverse incentive structures as governments would need to balance their desire to deliver high quality services with 'cutting to the cloth' of the funding provided and the efficiencies that might be contained within that.

It may also perpetuate the 'blame game' as the level of government providing the service is likely to argue that funding is not sufficient to deliver high quality services. Similarly, the level of government providing the funding is likely to argue that service delivery is not as efficient as possible.

Although the Commonwealth would be clearly responsible for funding preschools, this option could 'muddy the waters' on who is ultimately responsible for the quality and availability of preschool programmes or for making sure children are ready for school.

Option 3: The Commonwealth and the States and Territories continue to share responsibility for funding for preschools but establish more durable arrangements

The Commonwealth and the States and Territories would share responsibility for preschool funding (as they do now), but with greater certainty around funding arrangements rather than relying on time-limited agreements.

The Commonwealth would provide a funding contribution to preschool in LDCs via child care fee assistance, and commit to an ongoing and durable partial contribution to the States and Territories for dedicated preschools.

Each government's contribution could be set at a fixed proportion of total preschool funding, based on enrolment numbers and the cost of providing an agreed service, taking into account enrolment growth and where the cost may be higher to meet the needs of children in regional or remote areas, Indigenous children, or children with disability.

With the total pool for preschool funding at around \$1.2 billion per year, the cost for each State or Territory will be different, depending on how they deliver services, and how the funding split is agreed.

The other existing arrangements for policy, regulation, and service delivery would continue, but there would be an additional focus on ensuring regulatory arrangements for preschools did not constrain the delivery of services—especially for non-government schools that wish to offer

preschool services, and those preschool services that have the capacity to provide outside school hours care.

This option would provide greater funding certainty and durability.

Last minute funding extensions to the States and Territories would cease, and service providers would have a greater capacity to plan, which should result in better services for children and families.

Funding certainty, and the better services that should result from having that certainty, will also support the push by all governments to ensure fairness and equity across the sector.

This option is not a significant departure from the status quo, but it would allow governments to take an incremental approach to building on the positive reform work of recent years.

The continuation of shared arrangements, however, would not necessarily provide clarity for parents about which level of government is responsible for the delivery of preschool services.

Option 4: States and Territories fully responsible for preschools and the Commonwealth fully responsible for child care

The States and Territories would be fully responsible for preschool—including responsibility for policy, funding, regulation and service delivery.

The States and Territories would be responsible for funding the preschool hours delivered in LDC (currently 15 hours per week), with the Commonwealth supporting the balance through its fee assistance.

The Commonwealth would be fully responsible for child care policy, funding, regulation, and service delivery. It would no longer have a role in preschool policy and funding.

The Commonwealth and States and Territories would collaborate to retain the NQF, with the Commonwealth responsible for applying regulation in child care centres, and the States and Territories responsible for applying regulation in preschools.

This option would improve accountability by making it clear which level of government is responsible for preschool and which is responsible for child care.

Over the long term, this could improve services by allowing States and Territories to be fully in control of all the levers for preschools.

This could mean they would have more ability to influence the arrangements they put in place between preschool and schooling and efforts to make children 'school ready', and allow for greater policy coherence between these junctures.

This option, however, is at odds with recent moves to integrate child care with educational elements of the sector and could be a disincentive for providers to offer both child care and early learning.

This option wouldn't necessarily ensure fairness across the sector as a whole. It could mean some families miss out on a preschool programme, particularly the children of working parents, if States and Territories decided not to fund preschools in LDC (nationally, around 40 per cent of children undertaking a preschool programme do so at an LDC).⁵¹

It could also work against any further structural reforms of the sector in years to come.

Further, because preschool funding varies significantly across jurisdictions, the impact on those States and Territories, like Victoria, New South Wales, and Queensland, that have more LDCs delivering preschool, would be bigger than the impact on States and Territories that deliver preschools through their schooling systems.

Other reform options we considered

Other reforms are possible.

One option considered was to split roles with one level of government being the full funder of the entire sector, and the other level of government assuming responsibility for setting policy, undertaking regulation, and the delivery of services.

This model could see the Commonwealth combining all of its existing funding for all child care and early learning (including preschools) into a single subsidy (a fixed amount) to be paid to families, providers, or States and Territories.⁵²

There are significant differences between the nature and delivery costs associated with the different types of services available in the sector. Accordingly, it would be quite complex to develop a single subsidy for them.

The States and Territories would be responsible for policy, regulation, and service delivery, but would not be holding the 'purse strings'.

As discussed under Option 2, this has challenges that would need to be considered. Governments have an incentive to ensure services are delivered efficiently when they are also responsible for funding. This incentive can be lost when funding and service delivery roles are separated.

4.2.2 Schools

How Australia's schooling sector is performing now

According to the OECD, Australia has a high quality, high equity schooling system.⁵³

⁵¹ Australian Bureau of Statistics, *Preschool Education Australia 2014*, cat. no. 4240.0, ABS, Canberra, 2015.

⁵² This means the Commonwealth would no longer directly distribute funding for: the NQF; universal preschool access; professional development programmes; and various accessibility and equity programmes.

⁵³ OECD, *Education Policy Outlook 2015: Making Reforms Happen*, OECD Publishing, Paris, 2015: <http://dx.doi.org/10.1787/9789264225442-en>

Each year, 9,000 plus schools provide the opportunity for around 3.7 million Australian students to gain the knowledge, skills, and personal qualities to flourish in life and work.

Australian students have access to free schooling through State and Territory run public schools.⁵⁴ Parents can also choose to pay to send their children to non-government schools which also attract some public subsidy.

Schooling in Australia is a significant investment from all governments. In 2014, spending on schools made up almost 9 per cent of total government expenditure (around 4 per cent of Commonwealth expenditure and 16 per cent of State and Territory expenditure).⁵⁵

In 2012 the Commonwealth contributed \$13 billion to schools (including transfers to States and Territories) and the States and Territories contributed \$26 billion.⁵⁶

Governments have been focused on getting schools funding right so that it supports the educational needs of students, both in terms of the quantum provided and the basis on which it is calculated. Spending by all Australian governments grew by 37 per cent, in real terms, in the ten years between 2002-03 and 2012-13. This growth in spending has been driven by, amongst other things, increasing school enrolments, and improved school retention rates, as well as smaller class sizes.⁵⁷

While how much funding schools get is important, it's not the 'silver bullet' to achieve better results—how it's spent matters more.

Even with this larger investment over the past ten years, we still haven't seen the improvements in performance we should expect. The performance of Australian students has slipped by some measures.

We now have fewer high achievers and more low performers than a decade ago and average test scores have declined.

Since 2000, we've been slipping in our performance on the Programme for International Student Assessment (PISA) as demonstrated in Figure 4.3 below. According to the OECD, out of 65 countries, we're now equal 17th in mathematics (we were equal 2nd), equal 8th in science (we were equal 3rd), and equal 10th in reading (we were equal 2nd).⁵⁸

⁵⁴ Many government schools ask families to make voluntary contributions to the costs of schooling their children.

⁵⁵ J Daley and C McGannon, *Grattan Institute paper: Budget pressures on Australian governments*, Grattan Institute, Melbourne, 2013.

⁵⁶ Australian Curriculum, Assessment and Reporting Authority, *My School 2013 financial data*, 2015.

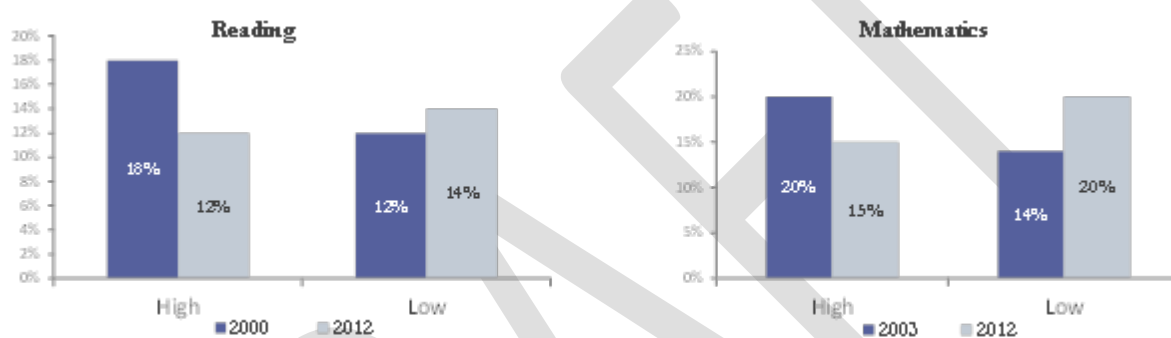
⁵⁷ J Daley and C McGannon, *Grattan Institute paper: Budget pressures on Australian governments*, Grattan Institute, Melbourne, 2014. Increases in funding also occurred as a result of programme funding, National Partnerships and through the Building the Education Revolution.

⁵⁸ S Thomson, 'International league: Australia's standing in international tests' *Teacher*, February. 2008 notes that when PISA first started in 2000 Australia ranked equal second in Maths and reading and equal third in science.

There are also particular pressures around Indigenous student attendance rates, with a strong link between school attendance and student performance. School attendance rates for Indigenous students are lower than for non-Indigenous students in every State and Territory. This gap widens as children age and tends to be significantly greater in remote and very remote areas.⁵⁹ Similarly, the average achievement and attainment of Aboriginal and Torres Strait Islander students lags significantly behind the performance of other Australian students.

In the last decade, all Australian governments have been working across a range of policy areas that the evidence suggests makes the biggest impact on student performance, including teacher and principal quality, curriculum, assessment, reporting and transparency, and school governance to try to reverse this trend.

Figure 4.3: Proportion of low and high performers in Reading and Mathematics



Source: Thompson, et al (2013) PISA 2012: How Australia measures up

The schooling sector within the Federation

To what extent, though, are the issues faced by our schools attributable to the way the Federation operates?

As noted earlier, the Commonwealth does not have specific constitutional responsibility for the provision of school education.

The Commonwealth, however, has increased its role in schools over time as it has sought to give effect to its own policy objectives and fill perceived gaps left by State and Territory policies.

This has resulted in the sector effectively being shared between the Commonwealth and the States and Territories in the areas of funding and policy setting.

While the States and Territories are primarily responsible for policy setting, the Commonwealth plays a leadership role in functions such as the national curriculum, My School and NAPLAN. Both levels of

⁵⁹ Commonwealth Department of the Prime Minister and Cabinet, Closing the Gap: Prime Minister's Report, 2015, Canberra, 2015, p. 12

government fund all school sectors, with the Commonwealth the primary funder of non-government schools, and the States and Territories the primary funders of government schools. Partially, as a result of the overlapping funding responsibilities, schools receive a different mix and amount of Commonwealth and State and Territory funding depending on where they are located and which sector they are in. This means that children with the same needs often receive different funding based on which school they attend in which State or Territory.

By contrast, delivery is more clear cut (the Commonwealth doesn't run any schools) as is regulation (State and Territory governments regulate their own government schools and non-government schools in their jurisdiction).⁶⁰

There are positive examples of this shared collaboration on policy. It has, for example, led to the creation of successful national education bodies and national reforms. National teacher and principal standards, the national curriculum, the consistent testing through NAPLAN and better information about schools through My School are all considered by stakeholders to now be essential parts of Australia's schooling system.

Furthermore, in remote locations, the Commonwealth and the States and Territories are working on a strategy to improve Indigenous school attendance, with the aim of closing the attendance gap between Indigenous and non-Indigenous students within five years.

But this shared space on policy and funding has also led to duplication, waste, and poor targeting of investment and effort.

This makes it hard for the public to understand which level of government is responsible for ensuring Australian children can access the best possible school education.

It also means the policy levers—to address things like improved teacher quality—are held across the Commonwealth and the States and Territories.

Box 1: Importance of teacher quality

Estimates based on Australian schools and teachers suggest that a student with a teacher in the top 10 per cent of teachers in the country could achieve in half a year what a student with a teacher in the bottom 10 per cent of effectiveness takes a full year to achieve.

Similarly, a student with a good teacher can achieve in three-quarters of a year what would take a full year with a 'less-effective' teacher.⁶¹

⁶⁰ The Commonwealth does a small amount of 'regulation' of the schooling sector. This is primarily related to establishing and confirming the continued entitlement to receive Commonwealth funding, performance reporting, and basic financial accountability. For example, the Commonwealth requires each school to pass its own 'fit-and-proper' person test to be eligible to receive Commonwealth funding, and to submit detailed financial information before it can receive funding.

Issues Paper 4: Roles and Responsibilities in Education includes more detail on how funding and policy is currently shared between the Commonwealth and the States and Territories.

Ineffective teachers can also put students at long term educational disadvantage.

A study in the United States showed that students performing at similar levels in grade two can end up with very different performance depending on the quality of their teachers. One student with a three year succession of high-performing teachers, and another with a three year succession of low-performing teachers, can have differences in performance of as much as 54 percentile points. Of concern is that subsequent effective teachers do not appear to offset the impact of ineffective ones earlier in a student's life.⁶²

At present, teacher quality is a shared responsibility—States and Territories are responsible for all teacher registration, and for the professional development, employment and management of public school teachers, while the Commonwealth has levers to influence teacher quality because it funds most initial teacher education courses through universities.

There are separate reforms occurring within each jurisdiction, as well as some reforms that are occurring nationally. For example, all Australian governments are implementing the *Australian Professional Standards for Teachers* and the *Accreditation of Initial Teacher Education Programs in Australia: Standards and Procedures* and also collaborating on the implementation of the Commonwealth's Teacher Education Ministerial Action Group report.

Multiple governments with a stake in the action also means more frequent change.

Arguably, constant chopping and changing through short-term programme funding has made it harder than it needs to be for schools to do their jobs and plan the allocation of their resources. It also makes it harder to gather reliable evidence about what works, and reduces the possible benefits of competitive federalism—where States and Territories trial different approaches and learn from one another.

Consequently, it can be more difficult than it needs to be for governments to decide where to spend the next public dollar to get the best 'bang for their buck'.

⁶¹ 'Effective' here means a teacher in the 75th percentile of teacher effectiveness, while 'less effective' means a teacher in the 25th percentile. The 'effectiveness' scale has been determined by analysing changes in the distribution of student scores from one assessment to another, administered two years later. See A Leigh, 'Estimating teacher effectiveness from two-year changes in students' test scores', *Economics of Education Review*, vol 29(3), 2010, pp.480-488.

⁶² W Sanders and S Horn, 'Research findings from the Tennessee Value-Added Assessment System (TVAAS) database: Implications for educational evaluation and research', University of Tennessee Value-Added Research Assessment Center, 1998.

How reform of the Federation can help achieve a better schooling sector: options for reform

Federation reform has the potential to address a number of the problems above.

It can help provide more certainty to the schooling sector, by making it clear to the public who is responsible for what aspects of the system. That does not necessarily mean that all of the arrangements that exist now need to change.

Stakeholders were clear that some of the national education functions (that governments collaborate on) work well and ought to be maintained. In particular, the following were seen to be particularly valuable:

- My School;
- the National Assessment Program (including NAPLAN and international testing like PISA);
- the national curriculum; and
- national principal and teaching standards.

As such, all of the reforms we consider below assume that these specific national features would be retained.

Four reform options are presented for consideration, drawing on the discussions at the stakeholder roundtables, and in close consultation with the States and Territories and the Prime Minister's Expert Advisory Panel.

The order in which the options appear in each sector does not indicate any preference.

Option 1: States and Territories fully responsible for all schools

The States and Territories would have full responsibility for all schools (policy, funding, and regulation of all schools and delivery of government schools) in their jurisdiction, including non-government schools.

States and Territories would make decisions about all areas of schooling including the funding and policy framework for non-government schools which could include funding guarantees being provided.

The only Commonwealth involvement would be in the national functions set out in the introduction to the reform options.

The States and Territories would be 'sovereign in their own sphere' and reflect their responsibilities as set out in the Constitution.

With full responsibility for schooling, States and Territories could encourage more consistent policy decisions, performance, and accountability measures across all schools.

This option would also provide absolute clarity to the public as to which level of government is responsible for schooling. It would, however, be a significant and historic shift from the split of responsibilities in the schooling sector that have built up since 1970 when the Commonwealth first began providing regular grants for non-government schools at flat per student rates.⁶³ This could promote better and more cost-effective service delivery by freeing up States and Territories to pursue innovative approaches to funding and policy across sectors without competing or complementary Commonwealth programmes.

Further, if this option was combined with Option 1 in the child care and early learning sector described above, it would provide a clear continuum of State and Territory responsibility for early childhood, primary and secondary school education.

While this option will provide more budget certainty for governments and potentially allow for better planning, it may not necessarily lead to increased certainty and stability in funding for schools.

For this option to work, States and Territories would need to consider how they could manage the issues relating to competitive neutrality of them funding and regulating their own government schools as well as non-government schools, and the funding guarantees over a number of years they could provide to parents of students in the non-government sector.

Option 2: States and Territories responsible for funding government schools and the Commonwealth responsible for funding non-government schools

The States and Territories would be fully responsible for government schools, and for education policy and regulation in non-government schools.

The Commonwealth would provide no specific funding for government schools (noting that the revenue States and Territories receive to fund public schools include untied Commonwealth GST grants). Conversely, the States and Territories would provide no funding to non-government schools.

The Commonwealth would maintain its funding relationship with non-government schools by exclusively funding those schools entirely. Funding would continue to be provided 'through' the States and Territories under Section 96 of the Constitution (where the Commonwealth relies on the States and Territories to pass on its funding payments and collecting its debts where required).

The Commonwealth would continue to be involved in the national education functions set out in the introduction to the reform options.

⁶³ D James, 'Federal-State Financial Relations: The Deakin Prophecy', Department of the Parliamentary Library, Research Paper 17, Canberra, 2001.

This option gives the States and Territories policy autonomy to set their own schooling policies for their government schools, and for setting education policy and regulation of the non-government schools, without interference from the Commonwealth.

It would result in clean lines of accountability as it would be clear which schooling sector each level of government is responsible for.

It focuses the Commonwealth's contribution on its historic emphasis on supporting parents who choose to send their children to the non-government schools, and the States and Territories' contribution on their historic role in ensuring universal access to secular school education. This option could, however, lead to very different funding models being applied across the States and Territories and between the government and non-government sectors, leading to differences in the level of public funding for schools with similar population characteristics.

This is likely to give rise to concerns about fairness, as well as introduce perverse incentives for governments to shift costs within the system.

With limited funding relationship between States and Territories and non-government schools (potentially only passing through Commonwealth payments), this option could reduce the States and Territories ability to effectively regulate and assist the non-government sector improve student performance, or to ensure a baseline of consistency that allows easy movement for students between schooling sectors.

It would also undermine the considerable degree of cooperation across the schooling sectors that has built-up over many years.

As with Option 1 above, the States and Territories would need to consider how they could manage the issues relating to funding and regulating their own government schools, as well as those schools' non-government competitors.

Option 3: Reduced Commonwealth involvement in school programmes

This option would essentially retain the status quo, but reduce the Commonwealth's involvement. The Commonwealth would reduce its involvement in a large number of programmes that are duplicative or could reasonably be done by the States and Territories.

It would not substantially change relative funding levels between governments, but there could be a relatively minor decrease in Commonwealth expenditure as it phases out some of its programmes.

The Commonwealth would continue to reduce its involvement in overarching policy, and limit that to the national education functions set out in the introduction to the reform options.

Commonwealth-funded programmes (i.e. those outside of ongoing, or what is known as 'recurrent', funding) would be limited to a small number of nationally-significant priorities.

It could also assist with other areas of high level national policy and national collaboration, but this would need to be agreed with the State and Territories.

While this option would not require significant structural change in the schools sector, it is a strong step towards the States and Territories having more autonomy in their own area of responsibility, and would provide greater clarity for the public as to who was responsible for schooling.

It would, however, require a cultural change at both levels of government. The Commonwealth would interfere less in schooling (through programmatic interventions), and providers (both public and non-government schools) would look less to the Commonwealth for targeted and supplementary programme funding.

With more State and Territory control over the priorities they want to invest in, less reliance on Commonwealth funding, and less risk of Commonwealth interference, this option would give more certainty for schools in each jurisdiction.

The Commonwealth could act as a 'catalyst' for national reforms where it is genuinely needed, and as agreed with the States and Territories. For this option to work, there would need to be careful definition of what qualifies as a 'national reform' to limit any regrowth of supplementary Commonwealth programmes and to ensure this is a durable arrangement.

Option 4: The Commonwealth is the dominant public funder of all students on an equal and consistent basis

Under this option, the Commonwealth would take on major responsibility for funding all students, regardless of what State or Territory they live in, or which school they attend. Each student would receive a funding entitlement, based on their educational needs and their family's capacity to contribute, that would 'follow' them to whichever school they attended.

The Commonwealth could do this by providing a funding contribution based on a national resourcing standard, adjusted for student need and the ability of families to make a contribution, using the existing funding mechanisms where payments are made through the States and Territories.

The standard could be similar to the existing Commonwealth Schooling Resource Standard which calculates how much funding is required to successfully educate a student based on their educational need. If it were to do this, the Commonwealth would need to take on significant additional funding commensurate with the current level of State and Territory schools funding.

The States and Territories would have the option to 'top-up' funding to government schools, if they wished to do so, to ensure all public school students, regardless of the ability of families to make a contribution, were able to attend for free.

The Commonwealth would continue to use the existing mechanism to make payments to the States and Territories for students attending government schools, and 'through' States and Territories to non-government schools on behalf of students attending those schools.

They would share responsibility with the Commonwealth on high level policy and the national education functions set out in the introduction to the reform options. They would retain responsibility for regulation (for example, school registration, teacher accreditation), and operational service delivery policy, particularly with respect to public schools.

This option is an ambitious change to the current arrangements.

Under this option, all students would be funded by the Commonwealth on the same basis—allowing funding to be targeted to better address disadvantage, provide certainty of funding to all schools, and promote parental choice as to the type of school they select for their child.

This approach builds on the funding model implemented by the Commonwealth in 2014. It should be noted that Commonwealth needs-based funding could also be used in providing the funding contribution it makes in all the other options discussed here (except for Option 1).

It would clarify for the public which level of government is responsible for funding, and which level of government was responsible for other aspects of the system.

The States and Territories would still be responsible for public schools, driving quality improvement, and enforcing standards, but would not be fully in control of the funding levers.

Having a funding model which only changes based on enrolment numbers and student characteristics should improve budget certainty and planning for the States and Territories and non-government schools.

For this model to work well, though, consideration would need to be given to how this might affect the fee setting structures of non-government schools, so that school fees were not automatically increased to take account of the Commonwealth's funding entitlement.

This option could also be a durable arrangement as parents would have a very clear and specific expectation about what level of funding their children are entitled to which would make it harder for the Commonwealth to change its funding approach.

Separating responsibility for delivery from responsibility for funding has both advantages and disadvantages.

It does not clarify who is ultimately responsible for schooling outcomes and so could encourage a continuation of 'finger-pointing' if outcomes did not improve—service deliverers are likely to blame inadequate funding, and funders are likely to blame poor service deliverers.

On the other hand, if the individualised funding entitlement genuinely empowers parental choice (noting that in some rural and remote areas, this is not always a reality), then providers—whether they are government or non-government schools—would have the incentive to focus on what they were able to offer in terms of value for money.

4.2.3 VET

How Australia's VET sector is performing now

Australia's VET sector plays a vital role in creating a high skilled and knowledgeable labour force which is needed to boost Australia's productivity and ongoing economic growth.

It delivers training to around 3 million students a year through more than 4,600 providers. It also supports disadvantaged young people, including Indigenous Australians, and young people in regional areas and areas where youth unemployment is high.

Overall, satisfaction with Australia's VET system is high.

In 2014, about 88 percent of graduates were satisfied with the overall quality of their training. This was similar to 2013.⁶⁴

⁶⁴ National Centre for Vocational Education Research, 'Student Outcomes 2014', *Australian vocational education & training statistics*, 2014, p. 6.

The States and Territories are the majority funders of the sector. They contribute around 70 per cent of the training subsidies (around \$4.1 billion of the estimated \$5.9 billion provided in 2014-15). The Commonwealth contributes around 30 per cent (about \$1.8 billion).

Expenditure on VET, however, has grown at a much lower rate than in the higher education and school sectors—it grew by 15 per cent in real terms over the ten years to 2012-13. Schools and higher education expenditure grew by 23 and 40 per cent in real terms respectively over this period.⁶⁵

The VET system is a shared responsibility between the Commonwealth and the States and Territories. It has worked well from the point of view of a national framework for policy, regulation, and products, which is then implemented by the States and the Territories to address local economic priorities. Many important features of the VET system, such as the Australian Qualifications Framework, national standards for training providers and training packages, the work of the National Centre for Vocational Education Research, and the Australian Skills Quality Authority (the national regulator), are formally agreed between both levels of government.

This has brought a number of benefits.

It allows the Commonwealth to have national oversight of the mobility and management of Australia's labour force and skills market. It can manage, at a national level, Australia's short-term skills needs, as well as looking to the future to plan what kind of labour market the economy as a whole may need. Some stakeholders, including the Business Council of Australia, have argued that Commonwealth involvement in VET is crucial because "employment is a national market and a national responsibility".⁶⁶

It also means that the States and Territories are well-placed to manage their local economies and respond to the need of regional and small-to-medium enterprises and their workforce needs by determining the nature of any interventions that may be required to address things like skills shortages in particular areas.

The system on the whole works well (especially given its complexities), but it can still be improved.

Most of the current concerns with the system relate to the quality of training and learning that is offered, and whether it meets the needs of students and learners, local labour markets, employers and industry.

Some qualifications are not providing the learning experience that students or learners need to get the job they are after, or may not work as well as they should in attracting those disengaged from, or marginally attached to, the labour market to get a job. There are also gaps in the quality of information that helps students and learners determine what course or qualification is needed to get a particular job, or be licensed for a particular trade.

⁶⁵ P Noonan, G Burke, A Wade and S Pilcher, *Expenditure on education and training in Australia*, Mitchell Institute analysis and background paper No. 01, 2014, p. 3.

⁶⁶ J Westacott, Swinburne University 2014 Chancellor's Lecture, 19 June 2014.

<www.bca.com.au/newsroom/swinburne-university-2014-chancellors-lecture-by-bca-ceo-jennifer-westacott>.

Industry and business groups are also concerned that some courses and qualifications are not providing the training and skills they are looking for. While in some areas there is high employer satisfaction with the system, in other areas it's declining.⁶⁷

Overlap and duplication by governments in the apprenticeship system also means that the system is costly and complex,⁶⁸ and not enough students are completing their apprenticeships.⁶⁹ Greater clarity about which level of government is responsible should provide them with the incentive to fix this.

Indigenous people are over-represented in lower level certificate courses and on average have poorer completion rates across all levels than other Australian students.⁷⁰ Stakeholders also stated that governments need to make better use of the VET system to build capacity in Indigenous communities by diversifying the skill base that exists there, and bringing skilled leaders back into regional and remote communities.

While they only make up a small proportion of the system, a small number of unscrupulous private training providers offer low quality or 'free' training or other inducements, and sign up students to unsuitable courses, which impacts on the overall reputation of the sector.

These concerns can deter students and providers, and undermine employers' confidence in the meaningfulness of some VET qualifications.

The VET sector within the Federation

To what extent, though, are the issues around quality and market responsiveness, attributable to the way the Federation operates?

There is already significant reform underway through all governments to address some of these concerns around quality, responsiveness to industry and consumer information. For example, on 8 May 2015, Commonwealth and State and Territory Skills Ministers agreed to work together to improve existing surveys and data collections about student outcomes.⁷¹

In terms of the Federation, though, the major problem to be solved is the current blend and mix of funding arrangements between the different levels of government.

Due to the formal and shared arrangements between the Commonwealth and the States and Territories, no one single level of government controls the distribution of VET funding, and there is

⁶⁷ Between 2011 and 2013 the proportion of employers using the VET system decreased 4.2 percentage points to 51.9 per cent. National Centre for Vocational Education Research, 'Employers' use and views of the VET system: 2013', *Australian vocational education & training statistics*, 2013, p. 1.

⁶⁸ Australian Industry Group, *Apprenticeships: Achieving Excellence*, 2013, p. 7.

⁶⁹ National Centre for Vocational Education Research, 'Completion and Attrition Rates for Apprentices and Trainees: 2013', *Australian vocational education & training statistics*, 2013.

⁷⁰ T Karmel, J Misko, D Blomberg, A Bednarz and G Atkinson, 'Improving labour market outcomes through education and training', Issues paper 9, *Closing the Gap Clearinghouse*, 2014, <www.aihw.gov.au/uploadedFiles/ClosingTheGap/Content/Our_publications/2014/ctgc-ip9.pdf>.

⁷¹ Communiqué for the COAG Industry and Skills Council Meetings, 8 May 2015.

little coordination between the two levels of government to ensure their funding policies are pushing in the same direction.

Both levels of government—to different extents—are grappling with the same four questions: (1) what courses or qualifications are to be funded, (2) to what extent, (3) in what volume, and (4) by what means?

The States and Territories determine how and what training they will fund—the Commonwealth makes a direct contribution to this through payments to the States, as well as making direct interventions in the system.

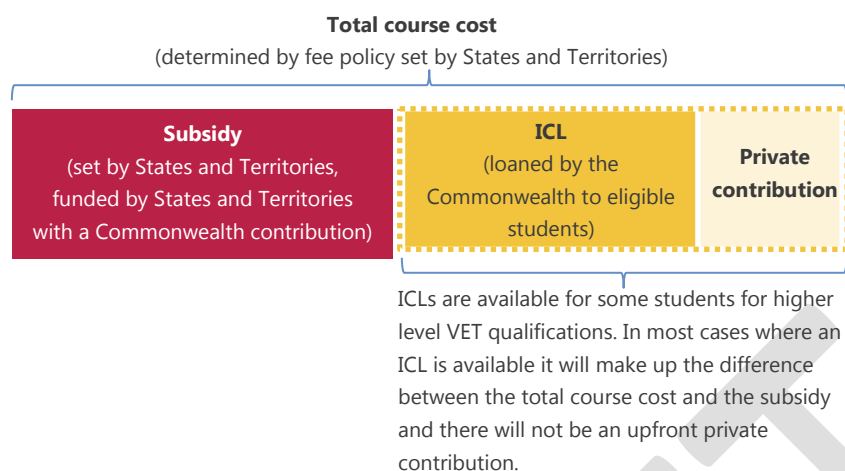
This means it is particularly difficult for governments to ensure financial support is properly targeted or channelled to the courses, qualifications or students that need it the most. It also makes it hard for the public to understand who is responsible for funding what.

At the moment, there is a complicated design mix of four components to meet the cost of a student or learner obtaining a VET qualification in Australia.

In the subsidised training market, funding is provided across different levels of government and, in some cases, by individuals, in the following ways (which is also demonstrated at Figure 4.4 below):

- States and Territories set fee policies in their jurisdiction (fees are regulated in some jurisdictions, so the State or Territory government determines how much training will cost—in other jurisdictions fees are deregulated so training providers can set fees);
- States and Territories also decide the value of the public subsidy for each course or qualification offered in their jurisdiction (States and Territories fund public subsidies with a contribution from the Commonwealth). Further, if students are unable to meet the cost of the private contribution—for example if they are unemployed—States and Territories may provide a fee concession, which effectively increases the public subsidy for that student;
- some VET students make private contributions to ‘fill the gap’ between the subsidy and the overall costs of the course, training or qualification; and
- the Commonwealth lends eligible VET students an income contingent loan (ICL—a loan where repayment is only required once the recipient reaches a certain income threshold) which limits or eliminates the need for students to pay course fees upfront for some qualification levels.⁷²

⁷² VET FEE-HELP is available to assist eligible students studying an AQF level 5 or 6 course with an approved provider, or a Certificate IV course nominated by their jurisdiction as part of a trial that concludes in December 2016. For more information, visit: <http://studyassist.gov.au>

Figure 4.4: The funding 'design mix' for the cost of a VET qualification

As a result, funding duplication and overlap can create perverse incentives that can affect the choices of students and learners and, sometimes, drive the behaviour of governments and providers—rather than working to support the delivery of better training and learning opportunities for Australians.

The way things work now, students and learners' choices can be distorted as they might choose a course that costs them less in upfront costs or attracts a higher subsidy, rather than on the basis of whether it will lead to a job or further learning.

There is also a lack of equity in the financial support for students between the VET and higher education sectors.

When studying through the higher education sector, most Australian students can access an ICL (either a HECS-HELP loan or FEE-HELP loan) to assist them with the cost of their tuition.

This means the majority of higher education students don't have to pay their tuition fees up-front. In VET though, only some students have access to similar assistance with an ICL (VET FEE-HELP) as it is only offered for higher level qualifications (that is, Diploma and Advanced Diplomas), and is being trialled at the Certificate IV level.

This means that many VET students have to pay some fees up-front which can influence the choice of sector they study in.

The current funding mix also means that one level of government can shift the costs of providing training or learning onto the other by minimising their contribution through the subsidy they provide, or the level of the ICL.

How reform of the Federation can help achieve a better VET system: options for reform

While funding arrangements in the sector need particular attention, there is support for the national framework for policy, regulation and products of the sector to continue to be a shared responsibility between the Commonwealth and the States and Territories.

Specifically, this means the following important parts of the sector will continue as they are currently now being implemented:

- existing nationally-consistent regulatory arrangements (including the operation of ASQA as the national regulator);
- the national standards for training providers and training packages;
- the AQF; and
- the publication of information and data to help students enrol in the right VET course, as well national research and evaluation of the sector by the NCVER.

This process offers the opportunity to reset the sector's funding arrangements and establish the right incentives for students, providers, and employers to maximise the value of their investment.

Three options are presented for consideration below, drawing on discussions at the stakeholder roundtables, and in close consultation with the States and Territories and the Prime Minister's Expert Advisory Panel.

Other reform options that were considered through this process, but not formally put forward here, have also been described briefly below.

The order in which the options appear in each sector does not indicate any preference.

Option 1: Clearer accountability through having one level of government in charge

One level of government—either the Commonwealth or the States and Territories—would be wholly responsible for the VET sector (including apprenticeships). This would include funding (providing subsidies and lending ICLs), policy (including fee policy), regulation, and service delivery.

The responsible government would control all the funding levers—the setting of fees, the payment of subsidies, and the lending of ICLs.

Either the Commonwealth or the States and Territories could assume full responsibility for VET:

1(a) Full Commonwealth responsibility

The Commonwealth would assume responsibility for the entire VET system, including apprenticeships, which are currently shared. The Commonwealth would be responsible for funding, policy, system design, and regulation.

The States and Territories could support specific priorities or local workforce needs, including through TAFEs in their jurisdiction, by providing extra subsidies for some courses, if they wished to do so.

1(b) Full State and Territory responsibility

The States and Territories would take on the entire VET system including funding subsidies for courses. Commonwealth funding for programmes such as the Industry Skills Fund, would cease.

The Commonwealth could continue to facilitate ICL repayment via the tax system, but they would be funded by the States and Territories.

This option would clearly place one level of government in charge of the system.

It would allow them to run a complete system, end-to-end, without interference from the other level of government.

Importantly, it places all the funding levers in the control of one level of government, allowing them to get the 'design mix' right between course cost, course subsidy and the ICL.

The responsible government would also have control over all the policy levers to address broader problems in the sector, such as quality concerns. This could promote better and more cost-effective service delivery.

Under Option 1(a), the Commonwealth would be able to make better links between the VET system and higher education, welfare, and employment. This would enable greater equity in the way courses are funded—both across sectors and for disadvantaged cohorts.

This option could, however, require major administrative change depending on how it was implemented.

It also risks losing the local responsiveness, appropriateness of interventions and diversity of offerings that come from having States and Territories responsible for their systems.

Under Option 1(b), the States and Territories could design the VET system to meet the needs of their jurisdictions, and allow them the opportunity to better manage the links between VET and schools.

They would be fully in control of determining the interventions to be made and executing them. This would encourage competitive federalism—but the resulting diversity would mean that the Commonwealth would lose the capacity to influence national workforce needs, or to more closely integrate the VET sector with the unified higher education system.

Option 2: Commonwealth focuses on skills shortages and incentives for employers

The Commonwealth would provide incentives for employers to offer and/or purchase training in areas of national skill shortage and lend ICLs (perhaps limited to AQF levels 5 and 6) to help individuals undertake training.

The Commonwealth would no longer provide the National Skills and Workforce Development Special Purpose Payment to the States and Territories.

The States and Territories would be responsible for all other aspects of the VET system—funding and setting subsidies for courses, managing the delivery of courses, and apprenticeships (both the public subsidies they attract and incentives for employers to take them on). They would also publish information and data to help students enrol in the right VET course.

This option gives each level of government responsibility for different parts of the sector.

The public would know that the States and Territories would be fully responsible for running the systems in their jurisdictions.

They would hold the important levers of funding (through the provision of subsidies), policy and regulation within their jurisdictions and would have a freer hand to design their systems to take account of local needs without interference from the Commonwealth.

The Commonwealth would be able to focus on empowering choice through lending ICLs to students and learners for particular courses and qualifications, and use its national perspective to look across the economy, and to the future, to consider what kind of labour market Australia may need, and what kind of national responses or incentives to employers might help deliver this.

These complementary roles would ensure the national perspective meets the local one.

If done well, it should result in ensuring that qualifications and courses meet the needs of students and learners for their immediate learning or training needs, while also contributing to the skilled labour force that industry and business need for the future.

There are, however, challenges with this approach.

Aspects of funding would still remain split over the two levels of government—the States and Territories would provide subsidies and the Commonwealth would lend ICLs. The challenges associated with the existing funding mix would therefore persist.

While the Commonwealth scheme would respond to national skills shortages, there is the potential for this to overlap with any State and Territory interventions also targeting skills shortages within their jurisdiction, unless it is effectively coordinated.

Option 3: A new agreed national framework for sharing and coordinating roles

All governments would agree a new approach to VET that provides for integrated, joint decision making within an outcomes-oriented framework aimed at better meeting the needs of students and employers.

As part of this, roles and responsibilities would be clarified and clearly articulated.

An approach within this option might be to split responsibility by qualification level or by function (policy, regulation and funding). For example, the Commonwealth could become responsible for funding diplomas and advanced diplomas (AQF levels 5 and 6) through subsidies and ICLs, leaving States and Territories to fund lower level VET qualifications through their existing subsidy system).

This option would formalise shared arrangements between the Commonwealth and the States and Territories, based on a deliberately designed framework for funding arrangements that is complementary and supports common objectives.

It could take many forms, including an intergovernmental statement, an outcomes-oriented funding agreement with clear conditions, or a national funding framework where the Commonwealth and States and Territories agree all the policy parameters in the system.

If done well, it would be clear to the public that governments were working together on the management of the system.

Under this approach, governments could consider agreeing to enhance and broaden the national training entitlement beyond the current commitment to a government-subsidised training place to a minimum of the first Certificate III qualification, to other qualification levels (for example, the Mitchell Institute has proposed a national tertiary entitlement across AQF levels 4, 5, and 6).⁷³

This could see more students and learners being able to access VET qualifications and courses.

Both governments could also co-design the main funding levers to improve how the subsidy and ICL might work together.

This could ensure financial support is more equitable for students and learners, and reduce any perverse incentives for them to choose the course or qualification they want based on the best financial arrangements on offer, rather than what will help them acquire the skills valued by employers, or to get the job they want.

Unless a new agreement clarified roles and responsibilities, however, there remains the risk that this option would not necessarily eliminate the cost-shifting between levels of government or provide greater accountability—it is likely to still be difficult for the public to know who is ultimately responsible for the VET system. It could also lead to complicated administrative and funding arrangements for providers to navigate if, for example, a different approach was taken for lower and higher AQF levels.

Other reform options we considered

A further option that was considered was one that retained the shared responsibility for funding between the Commonwealth and the States and Territories, but re-set how this could be provided by the different levels of government.

The Commonwealth could provide a direct and base funding contribution to all students, by committing to meet a fixed part of the costs of study (i.e. a fixed proportion that recognises the public value of VET).

The States and Territories could be responsible for lending ICLs (the role the Commonwealth currently plays now) and could also subsidise training that would help address local skills shortages. The Commonwealth could still facilitate repayments through the tax system.

⁷³ P Noonan and S Pilcher, *Financing tertiary education in Australia - the reform imperative and rethinking student entitlements issues paper*, Mitchell Institute Issues Paper, 2015.

While this option would support student choice and competition in the VET market, and could lead to a greater take-up of studies, it was considered to be highly complex to administer (the introduction of the Commonwealth's base funding contribution would be an additional funding to the existing subsidy and the ICL) while not necessarily improving accountability or simplifying funding arrangements.

It was, therefore, not considered further.

4.2.4 Higher education

Unlike the other education sectors, higher education is one of the 'cleanest' sectors in terms of how the Federation operates.

The Commonwealth is already largely accepted as the system manager, and provides the majority of funding, contributing \$14.6 billion in 2012 (59 per cent of higher education operating revenue),⁷⁴ with States and Territories contributing \$0.5 billion (around two per cent of operating revenue).

The States and Territories' play a particular role in relation to public universities, which are established under State and Territory legislation. This means they have a role in determining university governance arrangements and have a legal interest in the strategic and financial affairs of institutions, which can extend to control of assets and management of land.

In some instances, universities have extra red tape from having to report financial accountability and governance requirements to both levels of government.

There was agreement from stakeholders, though, that this is largely an administrative 'annoyance' rather than something that affected the student experience or made universities less competitive or sustainable.

Accordingly, only one option is presented for consideration in this process.

Option 1: Making it simpler for universities to meet regulatory requirements

The States and Territories would be offered the option of referring their responsibilities for public universities to the Commonwealth.

The Commonwealth would then introduce a legislative framework to facilitate this transfer of responsibilities. Importantly, this would not extend to land or asset transfers.

This wouldn't be a substantial change to existing arrangements and is mostly expected to be cost neutral for governments, with most costs falling to the Commonwealth for the development of the legislative framework and its implementation.

⁷⁴ This consisted of Commonwealth Government Grants and HELP contributions.

This option is proportionate to the challenge outlined above.

It gives the States and Territories the flexibility as to whether they wish to pursue this kind of reform—rather than initiate reform for reform’s sake.

If States and Territories opt-in, this option will reduce red tape for universities in those jurisdictions.

For those that do, the Commonwealth would take on responsibilities that are currently set out in university establishing acts, such as financial reporting, auditing, annual reporting, governance and oversight of commercial and financial decision-making.

It could, however, introduce more variation between States and Territories depending on if and how jurisdictions opt in.

States and Territories would retain land ownership and some oversight reporting under State and Territory-based financial management acts may still apply.

Another reform option considered

An option in which the Commonwealth takes over all aspects of public universities (except for land and asset ownership), through a referral of Constitutional powers from the States and Territories, was also considered.

It didn’t, however, meet the test of being a proportionate response to the problem identified above.

4.3 Housing and homelessness

How Australia’s housing assistance and homelessness services are performing now

Access to appropriate and affordable housing is fundamental to the wellbeing of Australians. It provides shelter and security and helps people to raise a family and participate in employment and the community.

Many Australians, however, find it difficult to afford housing that is safe, secure and appropriate to their needs.⁷⁵

In 2011-12, more than half of households on low incomes renting in the private market were in ‘housing stress’—paying more than 30 per cent of their income on housing.⁷⁶ Other Australians face additional barriers to securing or sustaining housing—such as mental health issues, domestic and family violence, or discrimination—and may be at risk of homelessness.

⁷⁵ Senate Economics References Committee, *Out of reach? The Australian housing affordability challenge*, Commonwealth of Australia, Canberra, May 2015, p. 24.

⁷⁶ Australian Bureau of Statistics, *Housing Occupancy and Costs, 2011-12*, cat. no. 4130.0, ABS, Canberra, 2013, p. 27.

Many Indigenous Australians, particularly in remote and regional areas, also experience additional barriers to securing and sustaining housing, such as overcrowding, poor housing stock, and a lack of housing options. Secure housing provides a much needed foundation to close the gap on Indigenous disadvantage.

It is important to remember that Australia's housing market, and by extension housing affordability, is influenced by a range of factors.⁷⁷

Some of these are beyond government control—like consumer preference and the cost of construction—but can be influenced by government policy.

But some of the factors affecting housing demand and supply are controlled by the different levels of government:

- The Commonwealth influences housing demand through policies in immigration, income support, and financial regulation.
- State, Territory, and local governments influence housing supply through planning, zoning, land release, and regulation.
- All levels of government influence demand and supply through tax settings.

Although they affect the housing market, these individual policy areas are not subject to extensive duplication or overlap in responsibility. They do, however, have an impact on the housing market, and therefore on demand for housing assistance and homelessness services. The way governments work together on these issues needs to be improved.

The focus of the Federation White Paper is to consider how the roles and responsibilities of governments are working in the areas of (1) housing assistance—made up of social housing and rent assistance, and (2) homelessness services.

All governments want to help Australians on low incomes access appropriate, affordable housing, recognising that housing is important for economic and social wellbeing.

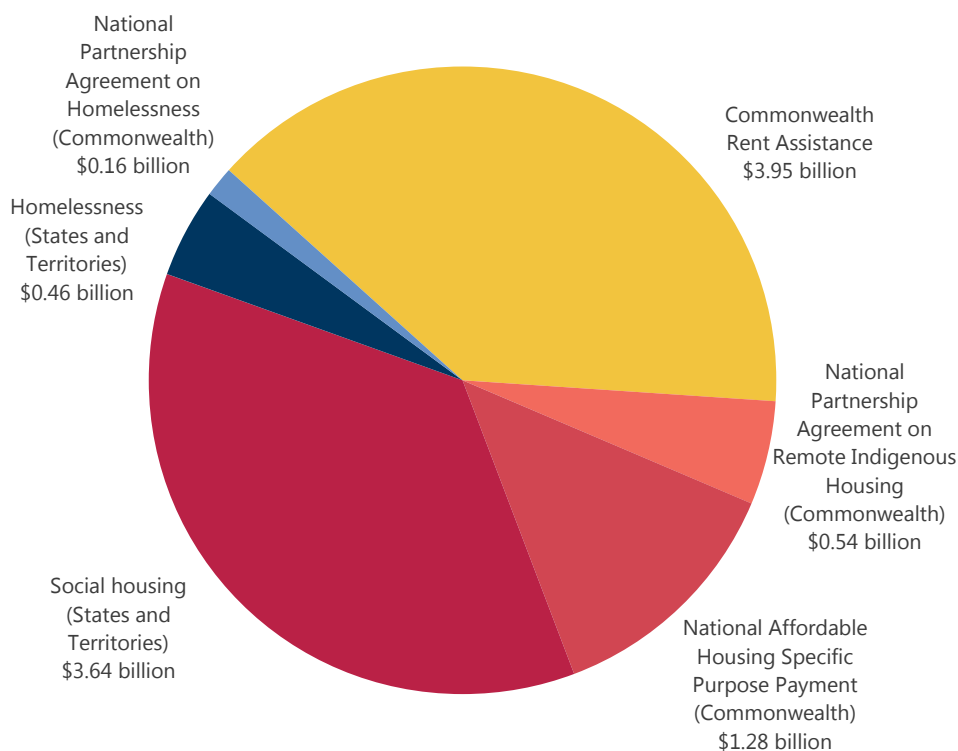
Specifically, governments want their housing assistance and homelessness services to:

- deliver high quality, well targeted services, that support individuals and families to access safe and affordable housing;
- support people to engage in work, education, and community activities; and
- avoid poverty traps, by creating pathways to long-term sustainable housing in the private rental or home ownership markets.

Figure 4.5 below shows the financial contribution of the Commonwealth and the States and Territories in housing assistance and homelessness services. The Commonwealth contribution is provided to the States and Territories, not used directly for service delivery.

⁷⁷ For a more detailed analysis of government roles and responsibilities in housing assistance and homelessness services see *Issues Paper 2, Roles and Responsibilities in Housing and Homelessness*.

Figure 4.5: Expenditure on social housing, homelessness services and Commonwealth Rent Assistance, 2013-14⁷⁸



Source: *Steering Committee for the Review of Government Service Provision, Report on Government Services 2015, Volume G: Housing and Homelessness, Productivity Commission, Canberra, 2015, pp. 17A.1, 18A.3, GA.1, GA.12.*

Social housing

Social housing provides subsidised low-cost housing and related tenancy management and support services, for people on low incomes who cannot access accommodation in the private market. Social housing also acts as a welfare safety-net for people with high and complex needs, such as chronic health conditions, disability or mental illness. In some remote communities, social housing is the only option for residents given the lack of a diverse housing market.

Forms of social housing include (1) public housing, which is owned and managed by State and Territory housing authorities, (2) community housing, managed by community organisations who lease

⁷⁸ State and Territory expenditure has been calculated as total spending less Commonwealth transfers (via the NAH SPP, and NPs on Remote Indigenous Housing and Homelessness). Social housing funding includes capital and recurrent expenditure. State and Territory social housing funding includes expenditure on Indigenous housing. The NAH SPP is used to fund social housing, homelessness services, and other services related to affordable housing. States and Territories have flexibility to determine how this funding is spent. Following funding for the Supported Accommodation Assistance Programme being rolled into the *National Affordable Housing Agreement*, the NAH SPP includes a \$250 million component notionally allocated to homelessness services.

properties or receive a subsidy from the States or Territories, and (3) State and Territory owned and managed Indigenous housing.

In 2013-14, all governments contributed around \$5.4 billion to social housing, assisting around 394,000 households.⁷⁹ The States and Territories are responsible for managing the delivery of social housing and have flexibility in determining how funding is spent, including the proportion of the *National Affordable Housing Specific Purpose Payment* spent on social housing.

In 2013-14, as part of its social housing contribution, the Commonwealth also provided more than \$500 million to the States and the Northern Territory to address overcrowding and the shortage of available housing through the construction of houses and delivery of housing services in remote Indigenous communities.⁸⁰

Recent changes in remote housing delivery⁸¹ focus on improving the sustainability and management of remote housing, in line with mainstream social housing systems. Over time, the intention is for remote Indigenous housing responsibilities to be aligned with broader social housing responsibilities, noting differences in operational costs, and land tenure arrangements.

Rent assistance

The Commonwealth provides Commonwealth Rent Assistance (CRA), an income supplement paid to income support and Family Tax Benefit recipients who rent in the private market, or are tenants in community housing. It is designed as part of the Commonwealth's social security arrangements; it is not a separate payment.

In 2013-14, around 1.3 million individuals and families received around \$4 billion in CRA.⁸²

Homelessness services

In 2013-14, all levels of government provided around \$600 million for specialist homelessness services,⁸³ of which the Commonwealth provided \$157 million to the States and Territories to support service delivery through the *National Partnership Agreement on Homelessness*.⁸⁴

⁷⁹ Steering Committee for the Review of Government Service Provision, *Report on Government Services 2015, Volume G: Housing and Homelessness*, Productivity Commission, Canberra, 2015, pp. 17A.1, 17A.4.

⁸⁰ Funding was provided under the *National Partnership Agreement on Remote Indigenous Housing* (NPARIH), a ten year National Partnership worth over \$5 billion. In late 2014, the Commonwealth agreed to the early exit of Victoria and Tasmania from NPARIH as both had met the objectives under the Agreement including addressing overcrowding and the need for improved Indigenous housing in remote communities. These States are now fully responsible for Indigenous housing in their jurisdictions.

⁸¹ The new Remote Housing Strategy was announced as part of the 2015-16 Commonwealth Budget and will replace the NPARIH.

⁸² Department of Social Services, *Annual Report 2013-14*, DSS, Canberra, 2014, p. 42.

⁸³ Steering Committee for the Review of Government Service Provision, p. 18A.3.

⁸⁴ States and Territories can also spend *National Affordable Housing Specific Purpose Payment* funding on homelessness services.

The States and Territories have responsibility for the delivery of homelessness services, either directly or through contracted providers. Services include supported accommodation, transitional housing, respite, counselling, advocacy, outreach support, meals, and financial assistance to people who are homeless, or at risk of homelessness.⁸⁵

Other assistance

Governments have also funded a range of other programmes to improve access to affordable housing, including:

- expanding the supply of affordable rental housing;
- assisting individuals to access the private rental market, for instance through loans for rental bonds, and brokerage services;
- assisting individuals to purchase housing, for instance through first home owner grants, shared equity schemes, and stamp duty concessions; and
- supporting Indigenous Australians to purchase housing, including in remote locations, through low interest and low deposit loans (delivered by Indigenous Business Australia).

Some of these programmes can serve multiple objectives—such as housing assistance, and economic stimulus and development.

Pressures on social housing assistance and homelessness services

Conditions in the broader housing market are the main factors influencing demand for government housing assistance and homelessness services. But it is important to acknowledge that demand for these services is also influenced by other factors, such as an individual's financial capacity and income (which influences their ability to obtain housing in the private market), and their particular circumstances and capacities (which influence and drive the choices they make).

People seeking to access public housing face long waiting lists—currently over 150,000 people⁸⁶—and the number of public housing dwellings is decreasing, in total and per capita.⁸⁷ The number of public housing dwellings nationally fell from 345,000 in 2004 to 324,000 in 2014.⁸⁸

In some areas, public housing stock is not well configured to match the profile of tenants who receive priority assistance. Larger free-standing homes are now under-occupied, as demand moves towards

⁸⁵ Steering Committee for the Review of Government Service Provision, p. 18.4.

⁸⁶ Steering Committee for the Review of Government Service Provision, p. 17A.5.

⁸⁷ Steering Committee for the Review of Government Service Provision, p. 17A.3; Australian Bureau of Statistics, *Australian Demographic Statistics*, cat. no. 3101.0, ABS, Canberra, 2013.

⁸⁸ Steering Committee for the Review of Government Service Provision, p. 17A.3

one and two bedroom units.⁸⁹ In contrast, many remote Indigenous communities experience severe levels of overcrowding in social housing.⁹⁰

Public housing is not sustainable in its current form.

The rental income States and Territories receive is insufficient to cover the cost of maintaining existing stock.⁹¹ Rents are tied to tenant income. Most tenants primary source of income is receive social security payments from the Commonwealth. This means the States and Territories contribute additional subsidies to cover the cost of providing social housing. This problem is exacerbated as properties age and the costs of property and tenancy management increase.⁹²

The community housing sector is expanding—by nearly 50,000 dwellings since 2004⁹³—and in some instances is building capacity to support specific population groups (for instance, young people and people with disability). The National Regulatory Scheme for community housing was set up in 2013 to create a national industry and provide certainty and confidence to investors.

Part of the expansion in the community housing sector has been the transfer of management of some properties from public to community housing. This may benefit some tenants. It also increases Commonwealth outlays, as community housing tenants are eligible for CRA, but public housing tenants are not.

Since 2007-08, CRA outlays have risen by nearly 50 per cent in real terms.⁹⁴ This is driven in part by rising rental prices, meaning more people are eligible to receive the maximum rate. It has also been driven by an increase in the number of people eligible for CRA.

At the same time, CRA is becoming a less effective subsidy. The value of the payment, which is indexed to the Consumer Price Index, has not kept pace with increases in rental costs.⁹⁵ Nevertheless, CRA plays a major role in relieving housing stress for many Australians on low incomes.

Homelessness services are also under pressure.

⁸⁹ Department of Family and Community Services, *Social Housing in NSW: a discussion paper for input and comment*, FACS, NSW, 2014 pp. 26-27

⁹⁰ Australian Bureau of Statistics, *Census of Population and Housing: Estimating homelessness*, cat. no. 2049.0, ABS, Canberra, 2011.

⁹¹ H Pawson et al., *Public housing transfers: past, present and prospective*, AHURI Final Report No. 215, Australian Housing and Urban Research Institute, Melbourne, 2013, p. 10.

⁹² Department of Family and Community Services, p. 6.

⁹³ Steering Committee for the Review of Government Service Provision, p. 17A.3.

In 2009, Housing Ministers agreed to develop, over time, a large-scale community housing sector, comprising up to 35 per cent of all social housing (Source: Department of Human Services, *Implementing the National Housing Reforms: A progress report to the Council of Australian Governments from Commonwealth, State and Territory Housing Ministers*, Victorian Government Department of Human Services, Melbourne, 2009, p. 17).

⁹⁴ Department of Social Services, unpublished.

⁹⁵ Australian Bureau of Statistics, *Consumer Price Index*, cat. no. 6401.0, ABS, Canberra, 2014; Australian Bureau of Statistics, *Residential Property Price Indexes: eight capital cities*, cat. no. 6416.0, ABS, Canberra, 2014.

Stakeholders observed that some of the most vulnerable people rely on homelessness services and one in three clients requesting assistance were escaping domestic or family violence.⁹⁶

Almost one in four people seeking accommodation from homelessness service providers in 2013-14 did not have their needs adequately met.⁹⁷ This was an increase from the previous year, despite a five per cent increase in government funding, in real terms.⁹⁸

Housing assistance and homelessness services within the Federation

To what extent, though, are the pressures on housing assistance and homelessness services related to the way our Federation operates?

Governments' efforts are largely focused on financial assistance that subsidises the cost of housing for people on low incomes (through both rent assistance and social housing) and helping people who need support to secure and maintain stable accommodation (through social housing and homelessness services).

Overlapping government roles and responsibilities

Currently, the Commonwealth and the States and Territories are both responsible for funding and setting high level policy for social housing and homelessness services.

Commonwealth policy influence and funding largely occurs through the *National Affordable Housing Agreement* and related National Partnerships.

The States and Territories have primary responsibility for the delivery and regulation of social housing (through State and Territory housing authorities or community housing providers) and homelessness services (usually through non-government organisations).⁹⁹

The Commonwealth has full responsibility for providing CRA, through the social security system, to people on low incomes renting in the private market.

Some stakeholders stated that there is limited accountability and transparency around how States and Territories use funding under the *National Affordable Housing Agreement*, making it difficult for the public to tell whether funding is being used effectively. Shared roles can promote national policy consistency and drive national reform, but they can also make it harder for the public to identify which level of government is responsible for housing assistance and homelessness services.

These shared roles can also be a catalyst for blame shifting between governments.

⁹⁶ Australian Institute of Health and Welfare, *Specialist homelessness services: 2013–14*, AIHW, Canberra, 2014, p. 39.

⁹⁷ Steering Committee for the Review of Government Service Provision, p. 18A.10.

⁹⁸ Steering Committee for the Review of Government Service Provision, p. 18A.3.

⁹⁹ In the Northern Territory, the Commonwealth holds a long-term liability over public housing in many remote Indigenous communities. Under these arrangements, the Northern Territory has a responsibility to maintain these remote public houses for a defined period.

The States and Territories can seek to blame any deficiencies in services on a lack of funding—both the amount and certainty of future payments—from the Commonwealth. In turn, the Commonwealth could point to poor or inefficient management of services and housing stock by States and Territories.

This draws attention away from addressing any issues in the system and improving services.

Equity in funding arrangements based on tenure

Some stakeholders stated that the different level of subsidy provided to tenants through public housing and CRA is unfair as people in similar circumstances can receive different levels of assistance based on their tenure type.

Public housing rents are highly subsidised to ensure affordability for tenants.

Rents are set as a proportion of household income—often a maximum of 25 per cent¹⁰⁰—rather than the market value of the property. This subsidy is intended to reflect the multiple and complex needs of some public housing tenants.

In contrast, people in the private rental market generally pay higher, market-based rents and receive CRA. The rate of payment for CRA is based on rent paid and does not increase once rent exceeds a maximum threshold.

This means people in public housing receive more assistance from governments and people in the private rental market often spend a higher proportion of their income on rent.

Stakeholders indicated that any changes to address unfairness in the levels of subsidy provided should consider the potential impact on existing public housing tenants, particularly those on very low incomes and those with complex needs.

Coordination of services

Because different levels of government are responsible for different parts of the sector, it is more difficult for services to be aligned and coordinated in a way that provides holistic housing services.

Stakeholders observed that, in addition to the relationship between housing assistance and homelessness services, housing is an important social determinant that influences and is influenced by health (particularly mental health), education, employment, and family functioning.

Stakeholders suggested there was room to improve integration and coordination between housing assistance and homelessness services and other service systems, such as health, welfare, employment, and social security.

Greater coordination would benefit individuals and families, and reduce costs for governments and taxpayers.

¹⁰⁰ Australian Institute of Health and Welfare, *Housing assistance in Australia 2014*, AIHW, Canberra, 2014, p. 27.

Some stakeholders expressed concern about the lack of data on government performance, although the importance of collection and analysis of data is not unique to the housing and homelessness sector. The availability of data has a direct impact on the ability of governments to coordinate and target housing assistance and homelessness services.

How reform of the Federation can help achieve better housing assistance and homelessness services: options for reform

Federation reform can address some of the problems identified above.

It could improve accountability, address inequities in rental subsidies, and improve coordination and integration across service systems—all of which can lead to improved services for citizens.

The options focus on the roles and responsibilities of governments in housing assistance and homelessness services. Under each option, all levels of government would retain existing responsibilities for broader policy settings that influence the housing market and housing affordability (such as land zoning and tax).

Governments could also consider a range of mechanisms to help them better co-design and manage their shared interest in addressing housing affordability issues. This could include (1) establishing a mechanism to support regular, ongoing discussion of government responsibilities that affect supply and demand in the housing market, and (2) commissioning periodic, independent reviews of costs and policy settings affecting affordable housing. These mechanisms could be consequences of the reform options on how governments could work better together that we discuss in *Chapter 3: Governance and accountability*.

In the same vein, where the options result in either level of government taking on additional roles or responsibilities with significant financial implications, the reform options set out in *Chapter 5: Federal financial relations* need to be considered such that each level of government has sufficient revenue to discharge their expenditure responsibilities. Collectively, Australian governments spend \$10 billion annually in housing assistance and homelessness services. The issue for the Federation White Paper process is whether this expenditure can be better used by reallocating roles and responsibilities—in particular the funding role—between levels of government.

Three reform options are presented below, drawing on discussions at stakeholder roundtables, and close consultation with the States and Territories, and the Prime Minister's Expert Advisory Panel. Each requires careful planning, management, and transition periods to limit disruption to the sector during implementation. The process for developing these options is described in *Chapter 2: Improving Australia's Federation*.

Another option considered through this process, but not formally put forward, has also been described briefly at the end of this section.

When considering which option is best, we need to be mindful of the criteria agreed by COAG, namely will the option: deliver better services, be fair, drive economic growth, provide clear responsibility, and be durable.

The order in which the options appear does not indicate any preference.

Option 1: A split system manager

The States and Territories would have full responsibility for funding, policy, service delivery, and regulation of social housing and homelessness services.

The Commonwealth would cease funding under the *National Affordable Housing Specific Purpose Payment* and the *National Partnership Agreement on Homelessness*.

The Commonwealth would retain full responsibility for CRA—including eligibility criteria and payment rates—and would extend eligibility to public housing tenants. Community housing tenants would retain eligibility for CRA.

The States and Territories would continue to be responsible for setting rents for public housing tenants and may choose to move towards charging market-based rents. The States and Territories would have responsibility for managing any transition to market-based rents.

The option could include the Commonwealth and the States and Territories jointly agreeing a national housing framework and collaborating on broader housing supply and affordability issues.

This option would clarify responsibilities—aligning State and Territory responsibility for social housing and homelessness services with related services (for example, family violence and community services) and with their responsibility (shared with local governments) for land zoning and planning, and building regulation.

It would maintain the alignment of Commonwealth responsibility for rent assistance with its responsibility for the social security system.

Clearer lines of responsibility could allow each level of government to more readily target and deliver assistance to those who need it, resulting in better services.

The Commonwealth could focus on providing financial assistance to help people on low incomes with the cost of rent. The States and Territories could focus on making social housing as efficient as possible.

Eligibility for CRA would be assessed for each individual based on their circumstances, not their tenure type—resulting in similar support for people in similar circumstances.

This option could improve the sustainability of social housing over the longer term, however, tenants may be worse off unless transitional arrangements are put in place.

This option does not address broader housing affordability issues, which place pressure on housing assistance and homelessness services.

Nor does it address concerns about cost and blame shifting. Decisions by one level of government—in either housing assistance and homelessness services, or in CRA and the broader social security system—could continue to have a financial impact on the other level of government.

Option 2: A shared system manager

The States and Territories would continue to have responsibility for policy, service delivery, and regulation of social housing and homelessness services. The Commonwealth would retain full responsibility for CRA.

Social housing and homelessness services would continue to be jointly funded by the States and Territories and the Commonwealth.

The Commonwealth and the States and Territories would jointly agree national priorities and reforms to deliver more integrated and innovative housing assistance and homelessness services, and to create pathways to affordable private rental and home ownership.

The States and Territories and the Commonwealth would work together to develop innovative strategies to address the causes of supply and affordability problems (for instance by creating incentives for investment in and increased supply of affordable housing to enable people to exit social housing).

Under this option, there would be no change to current expenditure responsibilities.

This option could include the Commonwealth and the States and Territories jointly agreeing a national housing framework and collaborating on broader housing supply and affordability issues.

This option acknowledges that both levels of government are responsible for policy settings that influence the broader housing market, which in turn creates pressure on housing assistance and homelessness services.

This option does not directly clarify responsibilities, however, it seeks to improve cooperation between levels of government in housing assistance and homelessness.

It could also help governments develop shared priorities in these areas.

This could help governments provide more coordinated and integrated support—ensuring clients don't fall through any 'services gaps'.

Under this option, governments could also work together to improve accountability and performance reporting mechanisms, which could include formal data sharing arrangements. It could also provide a framework for governments to consider issues around housing supply and affordability.

This option would rely on robust governance arrangements being established.

Option 3: States and Territories have full responsibility

The States and Territories would have full responsibility for policy, funding, service delivery and regulation of housing assistance and homelessness services.

The Commonwealth would no longer provide Commonwealth Rent Assistance and would cease funding under the *National Affordable Housing Specific Purpose Payment* and the *National Partnership Agreement on Homelessness*.

States and Territories would be responsible for managing housing assistance and homelessness services, determining local priorities and publicly reporting on performance.

States and Territories could choose whether to continue to provide rental subsidies, either through subsidised public and community housing or through financial assistance to people in the private rental market, and would determine eligibility and rates of subsidy.

This option could include the Commonwealth and the States and Territories jointly agreeing a national housing framework and collaborating on broader housing supply and affordability issues.

This option would provide States and Territories with clear responsibility and accountability for housing assistance and homelessness services. It would also align State and Territory responsibility for these services with their responsibilities for zoning, planning, and building regulation (some of which are exercised through local government).

This option could deliver better services. States and Territories could allocate funding more flexibly, maximising opportunities for reform across housing portfolios, ensuring long-term sustainability. Funding could also be used more flexibly to respond to local circumstances, address the needs of different client cohorts, and assist those with the greatest level of need.

Current inequities in the level of subsidy provided to renters in public and community housing and in the private rental market could be addressed, as rental subsidies for all three sectors would be the responsibility of one level of government. However, it may lead to different levels of support for people in similar circumstances in different jurisdictions.

Depending on how assistance for existing individuals is transitioned, this option could result in some Commonwealth Rent Assistance recipients being worse off.

This option would not resolve concerns about cost and blame shifting. Decisions by one level of government—in either housing assistance and homelessness services, or the broader social security system— could continue to have a financial impact on the other level of government.

Removing rent assistance from Commonwealth responsibility would break the link with the social security system, where rent assistance provided targeted support to households that need it. Separating financial assistance for housing from broader social security payments reduces clarity and

accountability about which level of government is responsible for ensuring the adequacy and sustainability of financial assistance to individuals and families.

This option would not directly address broader housing affordability issues. As one level of government would be responsible for funding all housing assistance and homelessness services, it would better align incentives to address the supply of affordable housing and ensure that services respond to changing housing costs over time.

This option would involve significant structural reform. Implementation would need to be carefully managed and transitioned over time.

Other reform options we considered

A further option we considered involved the Commonwealth assuming full responsibility for housing assistance and homelessness services.

This would be significant structural reform.

It would provide clear responsibility for housing assistance and homelessness services—the public would know which level of government was responsible for services. Reducing shared responsibilities would also improve durability and reduce incentives for cost and blame shifting.

There would, however, be significant barriers to implementation.

Issues around the ownership of State and Territory assets—the actual bricks and mortar that make up public housing stock—would need to be resolved. An appropriate Constitutional mechanism to support the Commonwealth's ability to take on a service delivery role in social housing would need to be considered.

The strong interdependencies with the planning responsibilities of State, Territory, and local governments would also need to be managed. These are a significant influence on housing supply and therefore on affordability generally, which affects demand for housing assistance and homelessness services.

CHAPTER 5: FEDERAL FINANCIAL RELATIONS

5.1 How do financial relations within the Federation work now?

Chapter 4 considered how expenditure responsibilities in health, education, and housing and homelessness could be allocated across governments.

This Chapter considers what reform may be needed to ensure each level of government has sufficient revenue to finance those responsibilities, specifically:

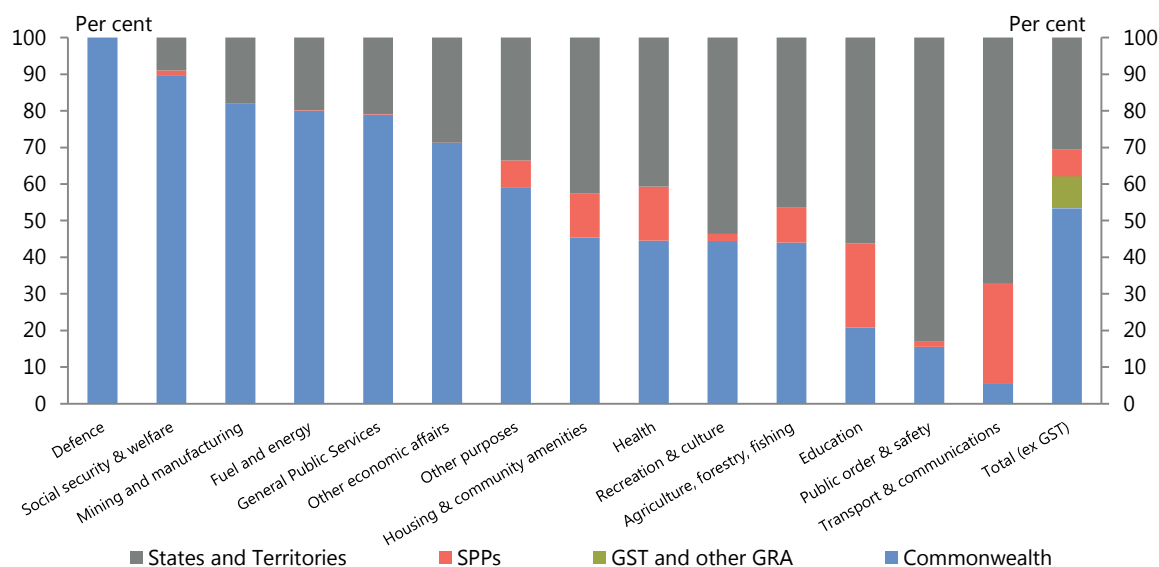
- how revenue is raised and distributed in the Federation, noting that the Tax White Paper will play a concurrent role in this process (see Box 3 below); and
- two important aspects of the current federal financial arrangements—vertical fiscal imbalance (VFI) and horizontal fiscal equalisation (HFE)—and possible reforms to address the issues associated with them.

The situation where a national government's spending responsibilities (in Australia's case, the Commonwealth) are less than its revenue, and sub-national governments' (in Australia's case, the States and Territories) spending responsibilities are greater than their revenue, is known as VFI.

Throughout the history of the Federation, State and Territory expenditure responsibilities—the services they are responsible for funding—have been greater than the revenue they raise.

A system of grants from the Commonwealth helps State and Territory governments meet their expenditure responsibilities.

Figure 5.1 shows the high level of State and Territory reliance on transfers from the Commonwealth across a range of areas of expenditure.

Figure 5.1: Commonwealth and State and Territory expenditure by function, 2013-14

Source: Commonwealth Treasury, 2013.

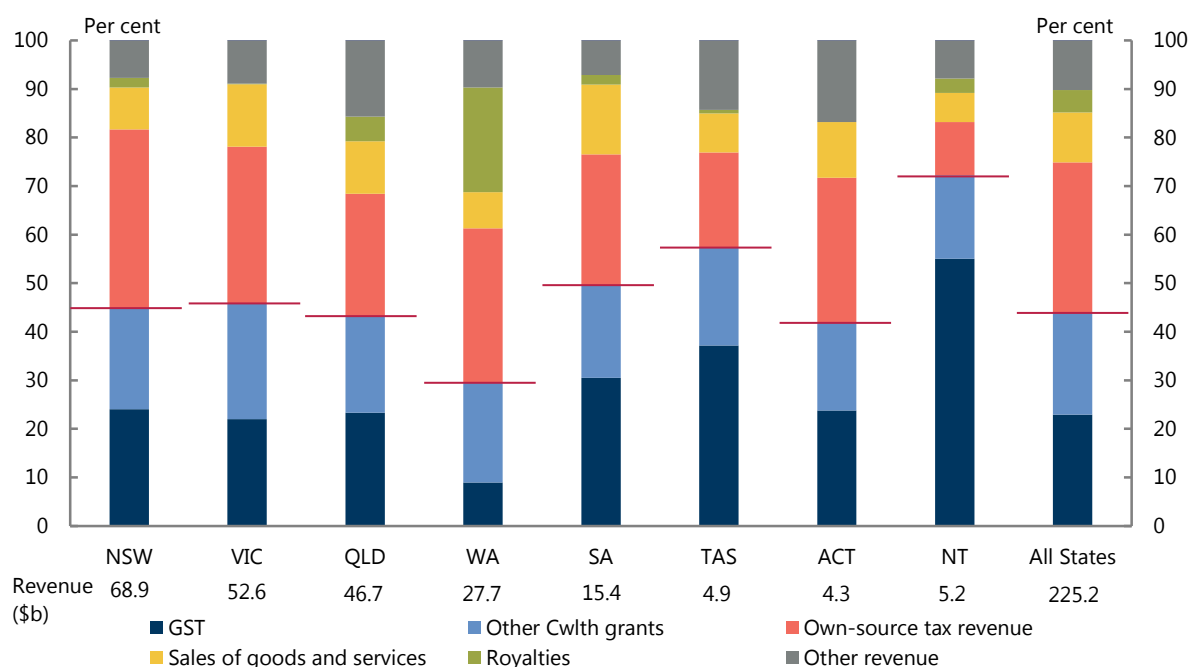
Note: these functions are drawn from the Government Purpose Classifications used under ABS Government Finance Statistics. Under these classifications, mining and manufacturing also includes construction; and agriculture, forestry and fishing also includes hunting. Funding from the GST and other general revenue assistance are included in the total; they are untied funding that States and Territories use to fund a range of functions.

These grants make up a significant part of all governments' budgets—about \$102 billion in 2014-15, accounting for approximately 45 per cent of total State and Territory revenue—and about 25 per cent of total Commonwealth spending.¹⁰¹

Some States and Territories receive more Commonwealth grants than others as a proportion of their total revenue. This is partly driven by the different revenue raising capacities and expenditure needs of each State and Territory (see section 5.3 below).

Figure 5.2 indicates the proportion of each jurisdiction's revenue made up of grants from the Commonwealth (the component under the red line).

¹⁰¹ Commonwealth Budget Paper No. 3 2015-16, pp. 3-5.

Figure 5.2: Revenue source by State or Territory, 2013-14

Source: *State and Territory budgets, ABS cat. no. 5512.0 and Commonwealth Final Budget Outcome 2013-14.*

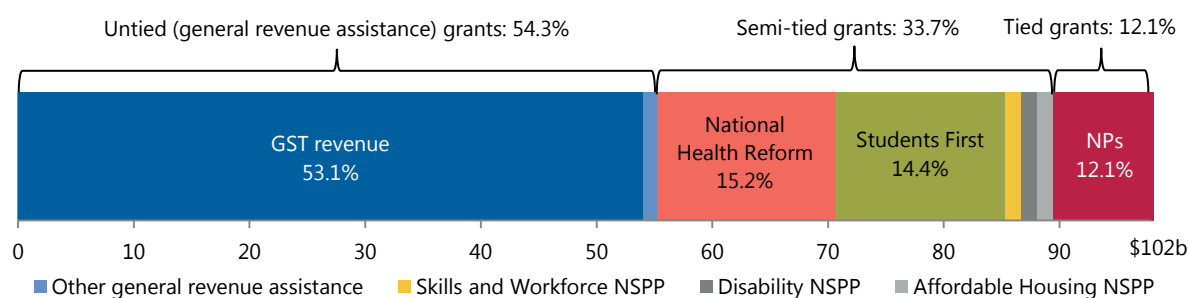
Just over half these grants are ‘general revenue assistance’, with the majority coming from proceeds from the Goods and Services Tax (GST)—which is raised by the Commonwealth and transferred to the States and Territories without conditions (‘untied funding’).

Most other grants are payments for specific purposes, provided to fund particular activities (‘tied’ funding, with varying degrees of conditions), under the 2008 *Intergovernmental Agreement on Federal Financial Relations* (IGA FFR), which is discussed in detail in *Chapter 3: Governance and accountability*.

The IGA FFR consolidated a wide range of specific Commonwealth-State agreements into six broad National Agreements: (1) healthcare, (2) education, (3) skills and workforce development, (4) disability services, (5) affordable housing, and (6) Indigenous welfare. With the exception of Indigenous welfare, the National Agreements were complemented by recurrent funding streams, called National Specific Purpose Payments (NSPPs). These funding streams were required to be spent in each broad sector, but without any specific conditions attached.

In addition to the National Agreements, there are National Partnership agreements (NPs)—separate specific agreements and associated payments aimed at supporting specific programmes. These payments are tied to agreed performance requirements.

A breakdown of how the Commonwealth funds the States and Territories is at Figure 5.3.

Figure 5.3: Breakdown of Commonwealth grants to States and Territories, 2014-15

Source: Commonwealth Budget Paper No. 3 2015-16 and Secretariat calculations.

As discussed in Chapter 3, there have been issues with the implementation of the IGA FFR, including the agreement of several major reforms outside the bounds of the IGA FFR, a proliferation of smaller NPs, prescriptions on service delivery (which create intergovernmental red tape), the lack of durability of some agreements, uncertainty around continued funding for expiring agreements and inadequate data sources.

Box 2: Local governments in Australia's federal financial framework

There are approximately 560 local governments in Australia, established under State or Territory legislation.

Local governments primarily rely on revenue from rates and charges as well as grants from other governments. Own-source revenue represents about 90 per cent of total local government revenue nationally.

The Commonwealth provides untied Financial Assistance Grants to local governments via the States and Territories. These grants are distributed in accordance with a set of legislated national principles, which include horizontal equalisation. Local government grants commissions determine the distribution of these funds amongst local governments in accordance with the *Local Government (Financial Assistance) Act 1995*.

The Commonwealth also provides funding directly to local governments for specific purposes, for example, under the Roads to Recovery programme.

The options presented below are not intended to foreshadow any potential changes to local government funding arrangements.

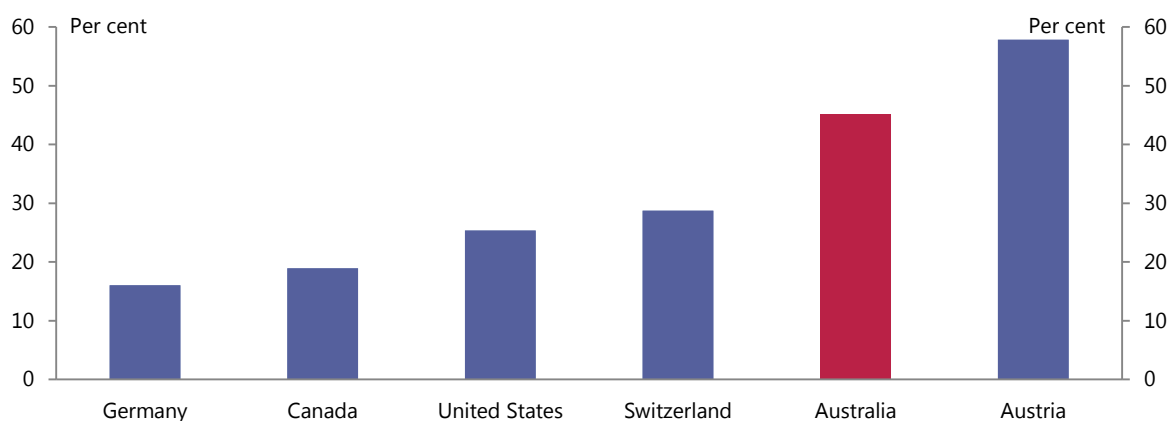
5.2 Vertical fiscal imbalance (VFI)

A disparity between revenue raising and expenditure responsibilities across levels of government is a characteristic of most federations.

Australia's level of VFI is high by international standards.

The Commonwealth raises 82 per cent of total tax revenue—the States and Territories raise 15 per cent and local governments the remaining three per cent.¹⁰² By contrast, in Canada (another Federation with similar characteristics to us), the central government raises only 45 per cent of total tax revenue. The level of VFI in selected federations is shown in Figure 5.4.

Figure 5.4: Vertical fiscal imbalance in selected federations



Source: IMF Government Finance Statistics Yearbook 2008, US Census Bureau State and Local Government Finance, 2011.

Note: VFI is defined as central government grants as a per cent of total sub-national government revenue.

In Australia, most major taxes (personal and corporate income tax and the GST) are levied under Commonwealth legislation.

The States and Territories levy a range of taxes, including on payrolls, land, and certain transactions such as stamp duty on property. They also impose royalties on mining and charge users directly for goods and services.

While the Commonwealth collects most of the revenue, the States and Territories have significant expenditure responsibilities—for instance, they are responsible for delivering important and costly services such as public hospitals and government schools.

VFI is not necessarily a problem in itself.

There are good reasons why one level of government might be better placed to raise revenue, or deliver services. The Commonwealth can collect most taxes at a lower administrative cost and compliance costs and red tape are lowered for businesses operating in multiple jurisdictions as they only have to deal with one set of uniform rules.

The main reason why the Commonwealth raises most of the tax revenue in Australia is the effective takeover of personal income tax by the Commonwealth during World War II to ensure the country had sufficient resources to support the war effort. After the war, the Commonwealth retained this revenue stream to fund major nation-building projects—such as the Snowy Mountains Hydro-Electric Scheme—as well as to expand social security.

¹⁰² Australian Bureau of Statistics, *Taxation Revenue, 2013-14*, cat. no. 5506.0, ABS, 2015, Canberra.

Some have argued however, that a high degree of VFI and/or a poorly structured federal financial framework can create the wrong incentives for both levels of government.

The Commonwealth, through tied grants under section 96 of the Constitution, can seek to exert policy influence in areas that are the responsibility of States and Territories. At times, this can foster a ‘one-size-fits all’ approach, undermining jurisdictions’ efforts to innovate and tailor services to local needs.

It can also facilitate the ‘blame game’, as it is perceived by the public that both levels of government are responsible for policy, funding and service delivery—when actually this is not the case.

VFI also allows the States and Territories to argue funding from the Commonwealth is insufficient, and the Commonwealth to claim that service delivery by the States and Territories is inefficient.

Receiving a significant proportion of their revenue through Commonwealth grants—and thereby being subject to unilateral decisions by the Commonwealth—can also affect the stability and predictability of State and Territory finances.

What ultimately matters, though, is how VFI is managed—the structure of funding agreements and the incentives they provide to improve service delivery and efficiency.

In light of the current fiscal pressures facing all levels of government (which will likely increase as the ageing population creates greater demand for services), we need to consider how these challenges can be managed to ensure long-term fiscal sustainability and economic growth.

Given the key links between VFI and Australia’s system of intergovernmental funding, reform options to address the revenue and expenditure imbalance are presented below, together with reform options on intergovernmental funding.

Box 3: The Tax White Paper

The Federation White Paper and Tax White Paper are being developed in close collaboration so that tax, revenue sharing, and expenditure proposals can be developed and considered together.

The Federation White Paper will consider the allocation of spending and policy responsibilities, and how tax revenue should be shared between all governments so they can meet their spending responsibilities. The Tax White Paper process is a comprehensive review of the tax system, including Commonwealth and State and Territory taxes.

Any reform that addresses VFI will need to be managed in connection with the tax process. Elements of the options below relating to tax will also be considered in the Tax Options Paper.

How reform of the Federation can help manage the revenue and expenditure imbalance and improve funding arrangements: options for reform

There is no magic bullet to reduce or manage the level of VFI in Australia and any changes to revenue and expenditure responsibilities will involve trade-offs.

When evaluating reform options, the five criteria identified by the Steering Committee, namely to deliver better services, drive economic growth, be fair, provide clear responsibility and be durable, should be borne in mind.

Two options are presented for consideration below and were developed in close consultation with the States and Territories and the Prime Minister's Expert Advisory Panel. The way in which reform options were developed is set out in *Chapter 2: Improving Australia's Federation*.

While these options are set out individually, this does not mean they are mutually exclusive. Aspects of some options could work well in combination with other options outlined in Chapter 3. Further, some of the options outlined in *Chapter 4: Key areas of reform* where we discuss expenditure responsibilities for health, education, and housing and homelessness could also affect VFI.

The order in which the options appear does not indicate any preference.

Option 1: Consolidate existing payments into an untied service delivery stream using a revised and reaffirmed IGA FFR

Recurrent service delivery funding the Commonwealth provides to the States and Territories would be provided through a single, untied funding stream and be delivered through a revised and reaffirmed IGA FFR (see option 2 in Chapter 3). This could include the current NSPPs.

The untied funding stream would be spent on agreed service delivery areas, which could include, for example, hospitals and schools. There could be a targeted set of public reporting on outcomes in these service delivery areas (see option 3 in Chapter 3).

Reform funding—to achieve nationally significant reform objectives in specific agreed areas—would be separated from recurrent service delivery funding.

The 'national interest' requirement for new NPs would be strengthened so that any new NPs provide time-limited funding only for matters that are truly nationally significant and where durable outcomes can be achieved from such time limited funding.

For this option to be durable, the single transfer would need to be fully transparent and not subject to discretionary change that allows the States and Territories to seek additional ad hoc funding from the Commonwealth, or the Commonwealth to unilaterally withdraw funding.

As a transitional arrangement, existing NSPPs could run to an agreed date, after which the pooled arrangements would begin, with the indexation rate of the single payment to be determined.

A reaffirmation of the principles and intended culture underpinning the IGA FFR (see Option 2 in Chapter 3) would support this option—making it clear that NP payments are intended for genuine reform, not for funding 'business as usual' approaches to service delivery improvement.

Close consultation between the Commonwealth and the States and Territories on expiring NPs could strengthen existing processes by clarifying expectations of whether they will be extended.

This option would provide States and Territories with greater policy autonomy, especially in terms of using funding to drive their own economic priorities. It would reduce the Commonwealth's ability to prescribe conditions on its funding in areas of State and Territory responsibility.

While this would not reduce VFI, it would address some issues associated with VFI by improving accountability and minimising the 'blame game'.

Option 2: Increase State and Territory access to tax revenue

Under this option, State and Territory governments could access untied tax revenue through any of the following measures:

2(a) A share of personal income tax

There are two broad ways to achieve this — 'making room' in the income tax base so that States and Territories can raise their own rates; or sharing the income tax revenue collected by the Commonwealth.

Under the first approach, the Commonwealth would reduce personal income tax rates by a certain amount and States and Territories would be allowed to apply a 'surcharge' of an equivalent amount. This is similar to the Canadian personal income tax system and would effectively allow for different levels of income tax across the States and Territories.

The Australian Taxation Office could collect the surcharge on behalf of the States and Territories. It would be 'own-source revenue' for the States and Territories and would reduce VFI, unlike the GST which is collected by the Commonwealth and provided to States and Territories as untied grants.

The tax rate would be legislated by the States and Territories. There could be flexibility to adjust the rate of the surcharge following an initial transition period. A minimum surcharge rate could be set to avoid the prospect of the States and Territories engaging in unhealthy levels of tax competition with one another.

Alternatively, the Commonwealth could transfer a fixed percentage share of personal income tax collections to the States and Territories. The share would need to be contingent on any wider changes to roles and responsibilities. The Commonwealth would not be able to vary this fixed share unilaterally. This approach would be similar to the German personal income tax system.

Under both approaches to this option, the Commonwealth would retain overall responsibility for income tax policy.

The transfer of fiscal capacity would need to be contingent on other changes to spending responsibilities and would effectively replace existing Commonwealth grants of an equivalent amount—that is, the additional revenue to States and Territories would be offset by a commensurate reduction in Commonwealth tied grants. Initially, this would leave the total tax 'take' unchanged and no governments would be worse off financially. It would need to be clear that the Commonwealth would not re-enter these areas of responsibility in the future.

2(b) Expansion of the GST

Changes to the GST rate or base require the unanimous support of States and Territories, as well as the endorsement of the Commonwealth and the passage of relevant legislation by both Houses of the Australian Parliament.

Under current arrangements, where all GST revenue (less the costs of administration) is passed on to the States and Territories, any change that results in increased GST revenue—by increasing the rate of the GST, broadening the goods and services it applies to, or both—would result in the States and Territories receiving more untied grants equal to the increased GST revenue.

2(c) Expansion of State and Territory own-source revenue

A broadening or deepening of States and Territories' revenue capacity could occur through reform of existing, potentially efficient taxes such as payroll tax or land tax. Such reforms could be part of a wider tax reform package.

For both Options 2(b) and 2(c), any broadening of State and Territory taxes could be offset by a reduction in Commonwealth tax revenue and Commonwealth tied grants, or other changes to roles and responsibilities.

Separately, a revised IGA FFR could set aside additional funding for national reforms in priority areas agreed by COAG. This could be managed through a dedicated reform funding pool.

It should be noted that these options are an important area of intersection with the Tax White Paper process. The options are canvassed here only to the extent they affect VFI and intergovernmental funding.

Details and discussion around the merits of changes to particular tax rates and bases is left to the Tax Options Paper.

Each of the above options has benefits and risks.

In Option 2(a), the surcharge method would more effectively increase public accountability as States and Territories could set and compete on the rate. This would, however, increase the complexity of the tax system and increase the risk of negative tax competition (a 'race to the bottom'). Additional administrative costs would be imposed on businesses that operate in multiple jurisdictions because of the effect of potentially different tax rates to payroll systems. A thorough exploration of the Constitutional and administrative issues around the surcharge would also be required.

The second method under Option 2(a)—the Commonwealth transferring a fixed percentage share of personal income tax collections—would be easier and less costly to administer. Because the States and Territories would not be able to compete on the rate, there would be no potential for negative tax competition. The lack of State and Territory discretion in varying the amount they receive limits the potential for this reform to enhance accountability of State and Territory governments to their electorates for revenue policy.

Either method would allow funding to be linked to growth in the income tax base.

Both approaches under Option 2(a) would involve the Commonwealth retaining the important role of setting income tax policy. In light of this, a process for taking into account States and Territories' views on the impacts of any potential changes to income tax policy would be necessary, as any changes the Commonwealth makes would have 'knock on' effects for the States and Territories.

Option 2(b)—expansion of the GST—would not, in itself, reduce the level of VFI, as unlike personal income tax, it cannot be regarded as State and Territory 'own-source revenue', because the High Court has determined that under the Constitution only the Commonwealth can levy this type of tax.

This option would, however, offer additional revenue autonomy for the States and Territories, particularly if it were to replace tied payments.

Such a change would need to consider how, and to what extent, any compensation to taxpayers and income support recipients would be funded. Options could include a change to the current GST arrangements so that not all the additional GST flowed to States and Territories, allowing some proportion to be used for compensation. There could also be a reduction in other Commonwealth grants to States and Territories.

All of the above options would improve revenue autonomy and certainty for the States and Territories. Option 2(c), however, is the only option that allows States and Territories to control their own taxes without Commonwealth involvement. It would give the States and Territories more control over their own revenue and flexibility to adjust tax policy to finance their own expenditure decisions.

Given the different capacities of States and Territories to raise revenue, however, consideration would need to be given to the fiscal equalisation implications of such a reform. The capacity of States and Territories to broaden their overall revenue may also be limited.

All options would ameliorate some of the negative effects and challenges of VFI, and increase efficiency and policy flexibility for States and Territories by reducing the level of conditional transfers between governments. They would also increase autonomy of the States and Territories by facilitating a reduction in tied Commonwealth grants and thus reduce Commonwealth involvement in State and Territory expenditure decisions. This would ensure clearer lines of accountability.

Option 3: Reallocate expenditure responsibilities to the Commonwealth

Under this option, VFI would be reduced by allocating more expenditure responsibilities directly to the Commonwealth to better balance its revenue raising capacity.

The Commonwealth could assume an increased funding and policy role in providing certain services, reducing State and Territory involvement and helping to clarify the role of each level of government. The States and Territories would have reduced policy and funding responsibilities. One consequence of this would be a reduction in Commonwealth tied grants.

Some of the options outlined in *Chapter 4: Key areas for reform* could facilitate the implementation of this option. For example, some of the Health options could potentially see a greater funding and policy

role for the Commonwealth, reducing the need for direct transfers to the States and Territories for service delivery in this area.

Any decision to change roles and responsibilities would need to be negotiated and agreed by all governments, rather than a unilateral action by one level of government.

Any affects from this approach on the efficiency and effectiveness of service delivery would need to be considered. Constitutional and administrative issues would also need to be examined.

5.3 Horizontal fiscal equalisation (HFE): the distribution of the GST

The States and Territories are inherently different, largely due to factors largely beyond their control—such as population size, demography, history, socio-economic status of citizens, geography, and access to natural resources.

These differences affect their capacity to raise revenue and the cost of providing services.

The Commonwealth distributes GST revenue to States and Territories in a way that reduces these disparities and seeks to ensure all jurisdictions have the fiscal capacity to deliver services and infrastructure of the same standard. Box 4 provides the formal definition of HFE which is determined by the Commonwealth Grants Commission (CGC).

The aim of HFE is to equalise the States and Territories' fiscal capacity to provide services and associated infrastructure. The actual services delivered are a matter for each State or Territory to determine and will largely depend on the policies each State or Territory chooses to pursue.

Fiscal equalisation has played a vital role in the history of Australia's Federation. Special grants to assist States and Territories with less fiscal capacity have been made since 1910, with the CGC established in 1933 to independently administer equalisation. Since 1981 Australia has had a system of full equalisation, where the relative needs of each State or Territory are assessed against the average fiscal capacity of all States and Territories.¹⁰³¹⁰⁴

Since 2000, the main mechanism used to achieve HFE has been adjustments to the proportion of GST revenue provided to each State and Territory.¹⁰⁵ All GST revenue—less the costs of administration—is passed to the States and Territories according to the principle of full equalisation.

¹⁰³ 'Full' equalisation means that, once fiscal capacities are assessed, the system aims to bring all States and Territories to the average fiscal level, in order for them to have the capacity to provide services and infrastructure to citizens at the same standard. While *full* equalisation is the objective in Australia, the CGC does not aim to achieve *precise* equalisation, since not all revenue and expenditure factors will be included, either because they cannot be reliably measured or that they do not have a material impact.

¹⁰⁴ Further information on the role HFE has played in Australia's Federation can be found in *Issues Paper 5: COAG and Federal Financial Relations*.

¹⁰⁵ Apart from the GST, there are other funding mechanisms that contain an implicit fiscal equalisation element. For example, many payments for specific purposes are distributed to States and Territories on the basis of need in a particular area.

While HFE in Australia is a longstanding practice, it is nonetheless a contentious area of federal financial relations. This is perhaps due to the ‘zero sum game’ nature of the system, where an increased share of the equalisation pool for one State or Territory reduces the share of other States and Territories.

Recently, the system has attracted attention because of developments in Australia’s mining sector, which has had a considerable effect on some States’ share of the GST in a short period of time. The mining boom has highlighted the way the CGC accounts for highly volatile revenue streams in the distribution of the GST.

Box 4: Mechanics and definition of HFE

The GST distribution is determined by the Commonwealth Treasurer based on independent advice from the CGC. The CGC considers a broad range of revenue and expenditure factors in determining the formula for redistribution. The CGC’s methodology is periodically reviewed, a process to which all States and Territories contribute.

The CGC’s current definition of HFE is:

“State governments should receive funding from the pool of goods and services tax revenue such that, after allowing for material factors affecting revenues and expenditures, each would have the fiscal capacity to provide services and the associated infrastructure at the same standard, if each made the same effort to raise revenue from its own sources and operated at the same level of efficiency.”¹⁰⁶

The CGC recommends GST revenue sharing ‘relativities’ to the Commonwealth Treasurer, indicating each State or Territory’s GST entitlement compared with its notional population share (or ‘equal per capita’ share). The CGC determines each jurisdiction’s ‘relativity’ based on their revenue and expenditure capacities, which are driven by innate factors such as those noted at the top of this section.

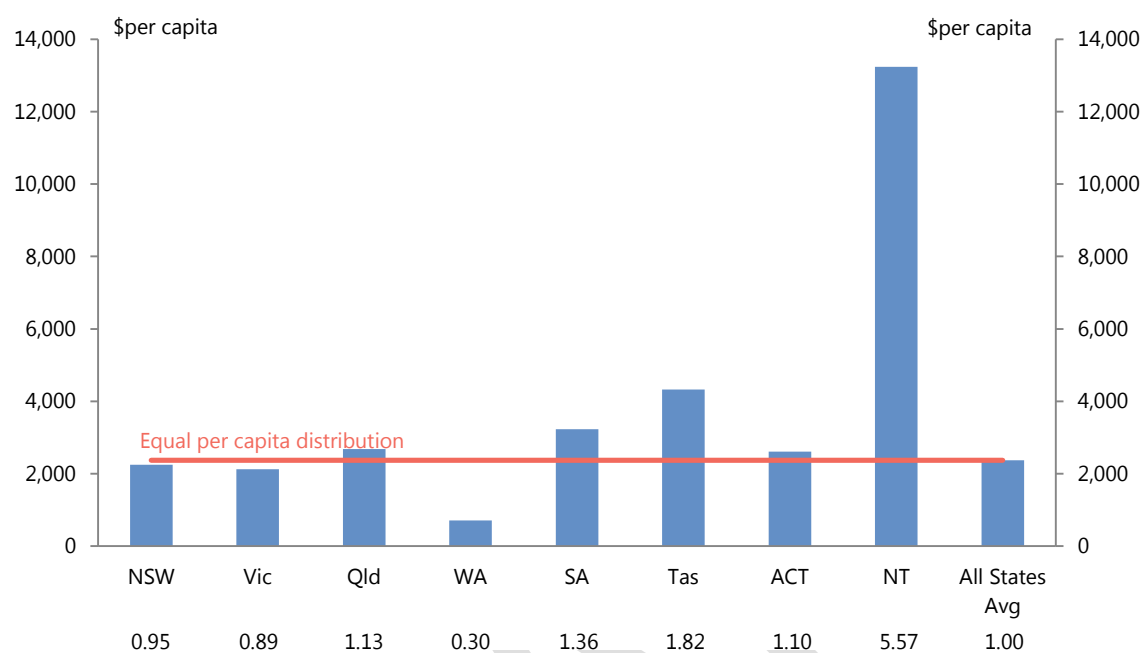
States and Territories with a fiscal capacity above the national average will receive a share of the GST pool that is less than their equal per capita share (making them ‘donors’), while States and Territories with a fiscal capacity below the average will receive a share greater than their equal per capita share (making them ‘recipients’).

Currently New South Wales, Victoria, and Western Australia are donors and the other jurisdictions are recipients. This changes over time as economies and demographic profiles evolve.

¹⁰⁶ Commonwealth Grants Commission, *Report on GST Revenue Sharing Relativities – 2015 Review*, Vol. 1, Canberra, 2015, p. 2.

Figure 5.5 compares the GST share of each State and Territory to their notional equal per capita share. It also shows the GST relativities for each State and Territory.

Figure 5.5: GST funding per capita and GST relativities, 2015-16



Source: Commonwealth Budget Paper No. 3 2015-16 and Secretariat calculations.

Horizontal fiscal equalisation: options for reform

Some argue the current HFE policy, which aims to achieve fiscal equality between jurisdictions, does not match public expectation and preference.

The current system is likely to be the best to achieve the goal of equality, if, as a nation, Australians think promoting equality between jurisdictions in terms of the level of services the States and Territories are able to provide is the primary consideration. It ensures that all jurisdictions can provide quality public services, such as health and education, which all citizens can enjoy regardless of where they live.

Some commentators, however, hold concerns that HFE implicitly discourages the economically efficient movement of individuals or investment to States and Territories with better economic opportunities or lower costs. Some observers also consider that HFE leads to poor policy results—for instance, by creating disincentives to pursue politically difficult tax reform and policies to promote economic development.

On the other hand, it is also important to recognise that HFE achieves important economic efficiencies by redistributing location specific revenue, such as mineral royalties, and avoiding people moving inter-state simply to achieve better services made possible by that revenue.

The 2012 GST Distribution Review found that while in some instances the current HFE system creates theoretical perverse incentives, there is little evidence they have a practical economic impact.

Lastly, some perceive that the current HFE system—which uses a time-lagged assessment methodology—does not respond quickly enough to volatilities in States and Territories’ revenue bases, particularly in the case of mining royalties. The CGC recently examined this issue and recommended no change.¹⁰⁷

All governments accept that some form of equalisation is necessary.

The question is—what form of equalisation will best serve Australia into the future?

If it is deemed that full equalisation—where governments have the fiscal capacity to provide the same standard of services to all citizens—should still be the goal, then option 1 would be preferred.

However, if there is consensus that something less than full equalisation is justifiable—even if it leaves some governments with less fiscal capacity to provide services to citizens—then a less comprehensive equalisation approach could be examined (options 2 and 3).

When considering which HFE option is best, the criteria that need to be borne in mind are those that have been agreed by COAG, namely to deliver better services, drive economic growth, be fair, provide clear responsibility and be durable. Arguably, it is the first three criteria—fairness, better services (through a capacity to provide an equitable provision of services nationwide) and economic growth that need to be borne most in mind.

The following three options look at possible different approaches to HFE, and have been developed in close consultation with the States and Territories and the Prime Minister’s Expert Advisory Panel. The process for developing reform options is described in detail in *Chapter 2: Improving Australia’s Federation*.

The order in which the options appear does not indicate any preference.

Option 1: Maintain the status quo, with changes to improve transparency

Under this option, the GST would continue to be distributed according to the objective of full fiscal equalisation, as defined by the CGC, so that each State and Territory has the fiscal capacity to provide services and associated infrastructure at the same standard.¹⁰⁸

The independent role of the CGC in recommending the distribution of the GST would continue. The CGC would also continue to conduct independent reviews of the equalisation methodology as directed by the Commonwealth Treasurer, which has occurred about every five years.

¹⁰⁷ Commonwealth Grants Commission, letter to Treasurer, *Advice on the Treatment of Large and Volatile State Revenues*, 27 February 2015. <

https://cgc.gov.au/index.php?option=com_content&view=article&id=221&catid=50&Itemid=373>.

¹⁰⁸ While this is termed full equalisation, it would not be ‘precise’ equalisation given the impracticality of measuring every revenue and expenditure factor driving fiscal differences between States and Territories.

The CGC would be best placed to examine the key drivers of the methodology, including the treatment of mining production revenue and costs associated with providing services to States and Territories' Indigenous populations.

Some additional measures could be considered to improve transparency and public understanding of the equalisation process. These could include activities to improve the public's understanding of the intent and operation of the HFE system.

This option effectively retains the status quo but enhances the transparency of the GST distribution process.

Any improvements to the operation of the equalisation system that increase the public's understanding of its objective would help to counter some of the misconceptions that exist about HFE—particularly around a perceived lack of transparency.

In this spirit, a more widespread programme of engagement by the CGC may help ensure HFE is better understood by opinion leaders, bureaucracies, and the general public.

The GST Distribution Review suggested that greater prominence be given to appearances by the CGC before parliamentary committees to provide methodological and technical background to its calculations. The Chair of the CGC could also provide an annual statement before Parliament following the release of that year's GST relativities.

Option 2: Less comprehensive equalisation through changing the current methodology

Under this option, the current methodology would be altered to move towards less comprehensive equalisation. There are a number of ways to achieve this.

2(a) Establish a GST relativity 'floor'

This option would set a minimum level of GST revenue to which any State or Territory is entitled.

This would mean donor States would not be able to fall below a set proportion—or floor—of their equal per capita (or population) share of the GST pool.

If one or more States or Territories had a high enough fiscal capacity to reach the floor, the GST redistributed to other States and Territories would be reduced. The proposed level of the floor would need to be developed in consultation with States and Territories.

2(b) Apply a discount on all revenue and expense assessments used by the CGC

In assessing how to distribute the GST, the CGC currently takes account of all significant revenue bases and expenditure undertaken by the States and Territories.

If a discount were to be applied, the CGC would be taking account of a lower proportion of these revenue and expenditure factors.

This would effectively reduce the redistributive effects of fiscal equalisation. States and Territories would no longer be equalised to the average fiscal capacity, with more of the GST distributed on an equal per capita basis. As a result, donor States would receive more GST, at the expense of recipients.

Option 2(a), the relativity floor, could be justified if one accepts the argument that every State and Territory should receive some minimum amount of GST revenue, noting that under the current arrangements it is theoretically possible—under extreme circumstances—for a fiscally strong jurisdiction to receive no GST.

The floor would potentially limit the extent of GST redistribution away from States and Territories with a very high level of fiscal capacity. This would effectively reduce the size of the pool available for full equalisation, and allow the fiscally strongest jurisdictions—those that reach the floor—to provide better services for a given level of taxation than others.

If, for instance, a floor of 0.5 were to be introduced, this would ensure that every State and Territory is entitled to a minimum of 50 per cent of their equal per capita share of the GST. If the floor—of whatever level—were to be reached by a State or Territory, all others would see their GST share reduced.

Hypothetically, if a 0.5 floor if it were introduced in 2015-16, GST funds would be redirected to Western Australia, given that their relativity in 2015-16 is 0.3. 2015-16, however, is likely to be an extreme example as the recent strength in mining royalty revenues in Western Australia has seen its GST share fall to unprecedented levels.

Although there are a number of ways to redistribute funds away from other States and Territories, one method could be to redistribute on an equal per capita basis.

Depending on the strength of the fiscally strongest jurisdictions relative to all others, a floor could be redundant in future years.

Western Australia's 2015-16 Budget projects its GST relativity to rise to 0.67 by 2018-19.¹⁰⁹ In this scenario, a 0.5 floor would not come into play. This means the operation of the GST would be unchanged.

The effect of *option 2(b)* is that recipient States and Territories would have a lower fiscal capacity than donor States and Territories, as they would not be fully equalised.

This option of discounting—at whatever level—places a greater weight on objectives other than equity, such as improved predictability and stability through the 'smoothing-out' of some fluctuations in GST distribution that could otherwise occur.

¹⁰⁹ Western Australian Government, *Budget Paper No. 3 2015-16*, Perth, 2015, p. 107.

More of the GST pool would be distributed on an equal per capita basis with less allocated for HFE, and an equal per capita distribution would be relatively more stable.

Discounting the level of equalisation could create efficiency incentives for States and Territories. For example, applying a discount to revenue assessments could increase incentives for States and Territories to pursue revenue policies that generate efficient economic growth, or adjust their revenues towards more efficient taxes. Applying a discount to expenses could reward those States and Territories that meet their service delivery responsibilities at lower expense.

The GST Distribution Review concluded, however, that the effects of this approach on efficiency would likely be marginal. Moreover, to achieve meaningful reductions in negative incentives, there would need to be a substantial reduction in equalisation.¹¹⁰ This could significantly affect the quality of services that some States and Territories are able to provide.

An equalisation discount would see all donor States and Territories benefit from increased GST revenue, at the expense of recipients. This is different from the floor model, where only the jurisdictions that reach the floor would benefit.

Option 3: Less comprehensive equalisation through a transition to an equal per capita distribution of the GST, with top-up grants to recipient States and Territories

Under this option, and subject to the unanimous support of the States and Territories, the GST would be distributed using a simple equal per capita formula.

Fiscal equalisation would occur outside the GST through top-up grants from the Commonwealth. The top-up grants would ensure States and Territories that are recipients under the current system are no worse off.

To ensure recipient States and Territories are not worse off, and donor jurisdictions receive the benefit of the equal per capita distribution, the top-up grant would have to be financed from some combination of (1) higher Commonwealth taxes, (2) increased Commonwealth debt, or (3) savings against Commonwealth expenditure responsibilities.

If this option were to be implemented in 2015-16, the Commonwealth would need approximately \$6.8 billion to top up current recipient States and Territories so they reach the average fiscal capacity and are no worse off compared with the existing equalisation process.

The top-up amount needed in future years would depend on the fiscal strength of each State and Territory and the average fiscal capacity. It is assumed under this option that the CGC would determine the top-up needed for each recipient State and Territory.

As recommended by the 2014 National Commission of Audit, this option would remove GST revenue from fiscal equalisation, improving GST revenue certainty for States and Territories. It would also

¹¹⁰ See finding 9.1, GST Distribution Review, Final Report, 2012.

reduce some of the institutionalised conflict between jurisdictions that arises from the current GST carve-up.

This option would result in increased revenue for donor States and Territories as they would receive extra GST. The fiscal capacity of the donor States and Territories would be substantially increased relative to the recipient States and Territories.

The distribution of the GST would be simpler under this option.

Moving the equalisation grant outside the GST would still leave a requirement for an independent body (the CGC) to determine the size and distribution of the top-up grant, with that grant requiring the same type of revenue and expense assessments used under the current system. The CGC's complicated task would, however, be limited to the top-up grant rather than the entire GST.

Given the significance of such a change, consideration should be given to transitional arrangements involving a move to an equal per capita distribution of the GST over time.

While the option assumes that the Commonwealth would fully absorb the cost of top-up grants to recipient States and Territories, consideration could also be given to a hybrid arrangement where the donor States shared some of that cost with the Commonwealth. Such proposals would need to be worked through as part of negotiations on wider Federation reform.

APPENDIX 1: TERMS OF REFERENCE

Background

The Australian Constitution established Australia's system of government as a federation comprising the Commonwealth Government and State governments.¹¹¹ One hundred and fourteen years later, Australia is a very different nation facing new challenges.

We remain a small population dispersed over a large land mass, but changes in technology and transport have connected us more to one another and to the world.

As a result, we are increasingly integrated into the global economy and society, and in particular the economic expansion and social transformations underway in Asia.

Our industries are undergoing significant and necessary restructuring, and the make-up of our population is changing: we have a greater proportion of people in older age groups, and a greater mix of people from across the globe choosing to make their home and their contribution here.

These new challenges mean that we need to make sure our federal structure is working. Our Federation is not, as some argue, a relic from the past, broken beyond repair and ill-suited to the times. Rather than seeking ever greater centralisation of power in the national government as a way of dealing with increasing complexity, now is the time to strengthen the way our federal system works by being clear about who is responsible for what.

According to the Australian Constitutional Values Survey 2012, the Australian public is generally supportive of a federal structure of government, but does not believe our Federation is functioning as well as it could be. Around two-thirds of Australians do not believe governments work well together, and believe the Federation needs reform.

A major part of the problem is that over time, the Commonwealth has become, for various reasons, increasingly involved in matters which have traditionally been the responsibility of the States and Territories. The States and Territories have become increasingly reliant on revenue collected by the Commonwealth to deliver services in the areas they are responsible for, with around 45 per cent of State and Territory revenue now coming from the Commonwealth.

Objectives

The Commonwealth Government has committed to produce, working with the States and Territories, a White Paper on the Reform of the Federation. The White Paper will seek to clarify roles and

¹¹¹ The Northern Territory and the Australian Capital Territory were conferred with self-government in 1978 and 1988 respectively

responsibilities to ensure that, as far as possible, the States and Territories are sovereign in their own sphere. The objective will be to:

- reduce and end, as far as possible, the waste, duplication and second guessing between different levels of government;
- achieve a more efficient and effective federation, and in so doing, improve national productivity;
- make interacting with government simpler for citizens;
- ensure our federal system:
 - is better understood and valued by Australians (and the case for reform supported);
 - has clearer allocation of roles and responsibilities;
 - enhances governments' autonomy, flexibility and political accountability; and
 - supports Australia's economic growth and international competitiveness.

Issues to be considered

Within the constitutional framework, consideration will be given to:

- the practicalities of limiting Commonwealth policies and funding to core national interest matters, as typified by the matters in section 51 of the Constitution;
- reducing or, if appropriate, eliminating overlap between Local, State and Commonwealth responsibility or involvement in the delivery and funding of public programmes;
- achieving agreement between State and Commonwealth governments about their distinct and mutually exclusive responsibilities and subsequent funding sources for associated programmes; and
- achieving equity and sustainability in the funding of any programmes that are deemed to be the responsibility of more than one level of government.

Consistent with this, the White Paper will present the Commonwealth Government's position in relation to:

- the values and goals that should underpin the Federation so it becomes more efficient and drives national productivity;
- principles and criteria to be applied when allocating roles and responsibilities between different levels of government, such as:
 - subsidiarity, whereby responsibility lies with the lowest level of government possible, allowing flexible approaches to improving outcomes;
 - equity, efficiency and effectiveness of service delivery, including a specific focus on service delivery in the regions,
 - 'national interest' considerations, so that where it is appropriate, a national approach is adopted in preference to diversity across jurisdictions,
 - accountability for performance in delivering outcomes, but without imposing unnecessary reporting burdens and overly prescriptive controls,
 - durability (that is, the allocation of roles and responsibilities should be appropriate for the long-term), and
 - fiscal sustainability at both Commonwealth and State levels;

- practical application of these principles in the allocation of roles and responsibilities in the areas of health, education, housing and homelessness (Issues Papers will be produced on these areas) and other areas within scope, to a lesser degree, including transport infrastructure, Indigenous affairs, justice, disability, welfare services, settlement services, family and parental support, disaster recovery, environmental regulation, adult and community education and youth transitions;
- how to address the issue of State governments raising insufficient revenues from their own sources to finance their spending responsibilities;
- the most appropriate approach for ensuring that horizontal fiscal equalisation does not result in individual jurisdictions being disadvantaged in terms of the quality of services they can deliver to their citizens, noting that this principle needs to be implemented in a way that avoids creating disincentives for them to improve their own revenue generation or to make the reforms necessary to improve the operation of their economies;
- effectiveness and governance of the current Intergovernmental Agreement on Federal Financial Relations, including the appropriateness of associated requirements in respect of inputs, outputs and outcomes;
- improvements to the Council of Australian Governments' (COAG) operations so it is a strategic, consultative and co-operative decision-making forum, including for facilitating mutual recognition (as opposed to harmonisation) of State and Territory regulation; and
- performance reporting, transparency and data arrangements.

The Federation White Paper will be closely aligned with the White Paper on the Reform of Australia's Tax System.

The White Paper will also draw on any relevant findings and recommendations of the Commission of Audit and other White Papers and review processes currently underway.

Governance and Consultation

The Department of the Prime Minister and Cabinet has established a Taskforce to develop the White Paper.

The White Paper will be a standing item on the COAG agenda and the Federation White Paper Steering Committee, chaired by the Commonwealth and involving all States and Territories and the Australian Local Government Association, will oversee the development of the White Paper.

The White Paper will be developed with extensive consultation with business, non-government experts and the community. The Prime Minister's Business Advisory Council will play a key part in providing advice to assist the development of the White Paper.

Timing

Issues papers will be released in the second half of 2014. The Green Paper will be released in the first half of 2015 and the White Paper by the end of 2015.¹¹²

28 June 2014

DRAFT

¹¹² The Commonwealth Government revised these timeframes in late 2014. The White Paper will now be released in 2016.

APPENDIX 2: SUMMARY OF STAKEHOLDER CONSULTATION ROUNDTABLES

Background

The Reform of the Federation White Paper Taskforce in the Department of the Prime Minister and Cabinet undertook the following series of ten consultation roundtables across Australia from 5 February to 5 March 2015:

- Canberra (5 and 6 February)
- Darwin (11 and 12 February)
- Melbourne (12 and 13 February)
- Adelaide and Hobart (16 and 17 February)
- Perth (18 and 19 February)
- Sydney (25 and 26 February)
- Wagga Wagga (27 February)
- Brisbane (3 and 4 March), and
- Townsville (5 March).

The purpose of the roundtables was to listen to stakeholder views on the questions raised in the issues papers published by the Taskforce, and hear their ideas for potential reform.

Participation was targeted to support discussion from a range of perspectives.

The following provides a summary of stakeholders' observations expressed during that discussion.

It is not intended to attribute any particular views to stakeholders or reflect formal positions. Instead, it aims to capture the key points of discussions or observations made.

Summaries of each roundtable are available at the Reform of the Federation website:

www.federation.dpmc.gov.au.

These summaries were also provided to the participants attending the sessions.

Key Themes

General Themes

Focus on citizens

- There was general agreement at the roundtables that reforms should make a positive difference to citizens and add value to public services. Participants didn't want reform for reform's sake.

State-specific challenges

- In addition to the common themes that emerged across all roundtables, stakeholders also raised unique challenges in particular jurisdictions. For example, at the Darwin roundtable non-government organisations explained the challenges of delivering services in the 'Top End', such as the wet season, the cost of training and high staff turnover. This emphasised the importance of having flexibility and local decisions on service delivery.

Clearer responsibilities and service delivery

- Participants felt that too many times levels of government were tripping over one another in delivering the same, or competing, policies and programmes. They felt there was need for all government to either get out of one another's way, or if there was a genuine need to co-design policies or programmes, to ensure they were done well and were the right fit. Participants felt they wasted too much of their time sorting out the different policies and programmes of different levels of governments.
- Related to this was the importance of preserving diversity as to how services are designed and delivered. Participants felt there was too much focus from governments on a 'one-size-fits-all' approach that did not take account of local considerations, and that all providers should have a freer hand to design, or adapt, services based on what was actually needed at the local level.
- Many participants felt that, while the Commonwealth should continue its national leadership role in bringing States and Territories to the table to agree national standards and frameworks for performance, priorities, goals and targets, the States and Territories and providers should be responsible for service delivery and operational policy decisions and have more autonomy and flexibility in how they do this.
- Some participants noted that, for service providers, it is often inefficient to work too locally and it is easier for them to work with communities on housing, or a school system or a regional network of schools, rather than individual schools.

Improving how governments work together

- Participants noted the importance of the durability of intergovernmental arrangements, and the need for all governments to develop working relationships that were resilient. There was a general sentiment that, often, relationships fracture too easily, especially when different political players or parties entered the arena, and that competing policy agendas actually did more harm than good in ensuring improvements in services and outcomes for individuals.
- Many participants felt that there were opportunities for reform in the way different levels of government interact. There were suggestions in some sessions that the setting of policies and programmes through COAG would be more durable if service providers and stakeholders were involved in their design and decision making.
- Further, in areas where it is not possible or feasible to have one level of government fully responsible for an area of activity, participants wanted to see greater emphasis on shared design or co-design between governments (e.g. the National Disability Insurance Scheme).

Accountability, transparency and the importance of data

- Participants recognised the critical importance of establishing clear responsibilities and public accountability so that users knew which level of government they should hold to account for the services they received, and how public funding was being used by governments.
- Participants strongly supported the role of independent mechanisms in providing clear and easily understood information on the performance of all governments, including how governments were spending their money.
- Participants were more reassured when independent and credible bodies that were at arm's length from all governments had a role in reporting on their performance. Institutions like the Australian Institute of Health and Welfare, the Australian Bureau of Statistics, and the Productivity Commission, were particularly valued.

Durability of policy direction and funding

- Participants expressed frustration with both levels of government 'chopping and changing' their policies and programmes, which meant they could never really have any certainty about their funding, see anything through, or plan well for the future.
- They also emphasised the need to allow sufficient time for policies or programmes to work or improve rather than abolish them when initial or early results are less than anticipated.
- However, it was also noted that flexibility was an important requirement in design and implementation and that programmes and policies should be dynamic and responsive and not necessarily always 'set in stone' or unable to be adapted to local conditions or special target groups.
- Participants also noted that durability of funding and policy direction could be improved through independent bodies that set standards and monitor performance, to promulgate best practice, and to provide transparency of funding levels and how funding is being spent.

The pursuit of national goals and objectives

- Many participants expressed a desire for the Commonwealth to continue to play a national leadership role in the setting of high level policies, and national goals and standards (whether they were funding, quality, performance or achievement, reporting, content or regulatory standards). Some participants felt that a range of important national policies or architecture would 'collapse' if the Commonwealth withdrew.
- Participants often cited the success of national plans with agreed national outcomes/standards/data like the National Mental Health Plan and the Melbourne Declaration (in schooling).

Specific challenges for regional and rural areas

- Regional and rural areas present specific and unique challenges to service delivery. Centres with a very small population may have difficulty providing the same level of services as larger regional or urban centres.
- Where appropriate, local level service delivery is preferable in regional areas. Areas that have a high-performing local government usually have better service delivery overall.

- Technology, access to services and access to skilled labour for schools and hospitals are all lacking severely in regional areas. This is also having a significant impact on the standard of living in these areas.

Consideration of Indigenous Affairs

- Many of the issues raised by Indigenous organisations echoed broader sentiments around the need to recognise jurisdictional diversity, improve accountability, and improve how governments work together.
- In particular, participants pointed to opportunities to make both mainstream and Indigenous-specific services work better through more integrated planning, better coordination between levels of government, and greater focus on community-based programmes.
- Across the board, participants held strong views that all levels of government need to re-think the way they work with Indigenous communities—it is vital that local people have a role in developing and implementing local solutions. Aboriginal Controlled Community Health Organisations were held up as an effective model, where Indigenous people are responsible for managing and delivering services to Indigenous communities. Some frustration was expressed that some of these organisations have lost funding for their policy role, when this was a critical element of their success.
- Community-based solutions are only possible with strong local leadership. Governments have a role to play in building the capacity of Indigenous communities through, for example, making better use of the VET system to diversify the skill base, keep students in school, develop young leadership, and bring skilled leaders back into regional and remote communities.
- Participants were of the view that there is a strong national interest argument to be made for ongoing Commonwealth involvement in Indigenous Affairs, in terms of both funding and leading national policy and standard setting.
- Participants also noted the importance of funding certainty and access to data. Funding for Indigenous services needs to reflect the relevant share of costs, not just a population share. For example, Indigenous people represent around 3 per cent of the population but have a greater burden of disease than the non-Indigenous population, and State and Territory health systems do not necessarily collect data on Indigeneity, so the real cost of health care for Indigenous people is likely to be understated.

Sector-specific Themes

Health

- Participants generally agreed with the analysis that the system works relatively well, but there are big gains to be made in effectiveness, efficiency and fairness through better coordination of care for those with chronic and complex needs.
- Participants suggested that the Commonwealth has an important national leadership role to play getting agreement to national frameworks, goals and objectives.

- Some argued that—ideally—a single-funder system should be at the centre of a long-term vision for the future of the health system, as this would align financial incentives for better integration of services and care coordination.
- Participants also considered that durability of funding, funding arrangements, and policy directions are important to provide certainty to consumers and providers. They also felt that accountability would improve if bodies, independent of government, performed key functions, such as data collection and reporting against nationally agreed targets and standards, and providing transparency of funding.
- Almost all participants agreed that e-health is critical. They consider it will improve communication across GPs, specialists, and hospitals and increase efficiency (e.g. reduce repeat orders of pathology or adverse reactions to medications).
- While there was agreement that consumer choice in health is a significant part of the system already, there was a need for governments to ensure consumers are supported in understanding and using health information to make appropriate decisions about their health.
- There were overarching concerns from participants that there is insufficient funding directed to preventive health, and an insufficient focus on the patient when looking at health issues and options (initiatives are often provider-focussed or clinician-led).

Early childhood and schools

- Many participants felt that Commonwealth involvement was essential to sustain the national architecture in early childhood (e.g. Australian Children’s Education and Care Quality Authority and the National Quality Framework) and schooling (national curriculum, Australian Curriculum, Assessment and Reporting Authority, Australian Institute for Teaching and School Leadership).
- Several participants suggested that the types of national programmes and policies carried out by these bodies would collapse if the Commonwealth withdrew, and that the agreement reached in the Melbourne Declaration would deteriorate.
- Participants questioned the focus on the economic value and workforce participation objectives of early childhood services, suggesting the focus should instead be on rights to access (equality) and quality.
- They also expressed concerns that the planning of provision (location of centres) is not being properly done by any level of government, resulting in over-provision in some areas and under-provision in others.
- Some participants noted that schools and local governments have capacity to deliver more early childhood services, but there are regulatory barriers. Some school-based services are covered by the National Quality Framework and State education legislation which leads to far too much complex regulation. Some participants felt that the Commonwealth and the States and Territories should work together to develop a ‘light touch’ national quality standard, against which not-for-profit providers and others could be accredited or certified to deliver the care. They were attracted to a one stop shop of standards and certification/accreditation of providers.
- Participants from the non-government sector want to continue its direct funding relationship with the Commonwealth and cautioned against any changes to these arrangements. These participants

also raised long-standing concerns about States and Territories acting as deliverers of schooling, but also as regulators of non-government schools (i.e. their 'competitors').

- In schooling, there was strong support for the Commonwealth providing a national leadership role and working with the States and Territories to set minimum national standards, but with the States and Territories and school systems being responsible for service delivery so long as there was flexibility for them in how this was achieved. Participants wanted to avoid a 'one-size-fits-all' approach.
- In terms of funding, most participants strongly supported the ambition of the pure needs-based Gonski Review funding model, but lamented its implementation.

VET and higher education

- Participants wanted to see an integrated national post-secondary training and education system. They were concerned that VET was often seen as the 'poor cousin' of the education system, and that its policy objectives kept being changed as responsibility moved to and from different government portfolios.
- While reluctant to attribute responsibility solely to one level of government, there was support for the Commonwealth playing a greater coordination role in national policy and regulation of quality training standards, with the States responsible for subsidising training and delivery of training. This arrangement could ensure that VET met local and national labour market needs, and ensure it was connected to Commonwealth policies for employment and income support. However, it was noted that higher education meets local labour market needs, even though it is managed by the Commonwealth.
- Some suggested there was a role for the Commonwealth in apprenticeships and that it would benefit from being a national system. The eight systems were considered very difficult to navigate for both employers, particularly those who operate across borders, and apprentices.
- There was significant discussion about the overlap and interaction between the VET and higher education sectors, especially in relation to higher-level qualifications. There was concern that recent reforms in higher education would intrude on the viability of VET providers already offering these kinds of qualifications. Concern was expressed about competitive neutrality and the different levels and types of funding available for students. While they understood the difference between VET and higher education, most participants wanted a system where students and learners could move in and out of post-secondary training, not a bifurcated system.
- Current roles and responsibilities in higher education do not reflect that the Commonwealth is largely responsible for it and wears the risk, but the States are responsible for its financial oversight and play a role in university governance arrangements.
- Some participants argued that some Commonwealth and State and Territory regulation is duplicative or competing, and are looking for nationally-consistent reporting requirements. Also, that some governance arrangements are too onerous, and that application of the principle of subsidiarity in these areas would allow universities to manage their own affairs.
- A number of participants suggested that States should not have a role in the establishment of universities; Tertiary Education Quality Standards Agency registration should be sufficient.

Housing

- There was a widespread view that the Commonwealth should continue to provide funding to the States for housing assistance and homelessness services assistance for the most vulnerable but with greater accountability and transparency regarding performance.
- Participants suggested that the Commonwealth should be wary of simply converting existing funding into Commonwealth Rent Assistance (CRA), and extending eligibility to public housing tenants, citing that this could disadvantage some tenants should rents be increased by state housing authorities.
- There was a view that clarifying roles and responsibilities would not address housing supply and affordability problems, and that governments needed to work together better to address housing issues, with the Commonwealth taking a leadership role. Some considered that the Commonwealth needed to establish a framework for, and be a part of, national planning.
- Participants felt there needed to be a durable approach to tackling housing supply and affordability irrespective of any change to roles and responsibilities. There was a view that a lack of consistency, over time, in government housing policies has dampened private investor confidence in government housing programmes.
- Participants were clear that there is no single national housing market, but differences in supply and affordability issues across the nation, and housing approaches required local and flexible responses.
- They thought that reforms to housing assistance should be considered alongside the likely impact of changes to the housing market that could flow from altering tax arrangements (negative gearing, capital gains tax and stamp duties). Participants noted the cost of various taxes, up-front charges and levies and compliance make it expensive to deliver affordable housing.
- Participants observed that there is an opportunity for governments to improve regulatory arrangements and support innovative approaches to housing finance, with a view to encouraging private investment in affordable housing.
- Some also observed that community housing providers are well placed to raise debt to finance the expansion of the social housing sector, as long as there is a stable and predictable revenue stream. They also thought private sector investment should be more strongly encouraged, but government policies to support this are needed.
- Participants also noted that the Commonwealth should focus on the impact of its income support policies, particularly welfare reform, on social housing and homelessness outcomes.

APPENDIX 3: PRIME MINISTER'S EXPERT ADVISORY PANEL

Role of the Panel

In his Tenterfield speech on 25 October 2014, the Prime Minister announced the appointment of an Expert Advisory Panel to provide expert advice and contribute to public discussion on aspects of the Federation White Paper.

The Panel is charged with providing advice to the Prime Minister, including ideas on reforming the Federation, and to provide input on key documentation and proposals as they are being developed. It also has a key role in advocating the need for reform to the federation, promoting the case for change and encouraging community awareness and engagement in the process.

To date, it has met on five occasions: 16 December 2014, and 23 January, 8 March, 6 May, and 1 June 2015. It also met with all Premiers and Chief Ministers at the COAG meeting on 17 April 2015.

Between them, the Panel members have extensive experience and expertise working within, or close, to the Federation, including as a former State Premier, Treasurer and senior Minister, as Board members of the former COAG Reform Council, working with and for the business community, and as respected academics in Australian federalism.

The members of the Panel are:

THE HON DR JOHN BANNON AO



Dr Bannon was Premier and Treasurer of South Australia from 1982 to 1992 and was National President of the Australian Labor Party from 1988 to 1992. He is involved in research, writing and lecturing on the history of federation, the Australian Constitution and federal-state relations in Australia. Dr Bannon is an Adjunct Professor of Law at the University of Adelaide and a Visiting Research Fellow at Flinders University. He has held a number of chair positions, including the National Archives of Australia Advisory Council, and was a member of the Australian Broadcasting Corporation Board from 1994 to 1999.

PROFESSOR GREG CRAVEN



Professor Craven is the Vice-Chancellor of the Australian Catholic University, a Board Member of Universities Australia and was the Deputy Chair of the COAG Reform Council. He is an expert in public law and has published numerous journal articles and books on constitutional law, government, public policy, constitutional history and federalism. Professor Craven has held a number of chair positions and is currently chair of the Teacher Education Ministerial Advisory Group. He is a regular contributor to public debate and columnist for *The Australian* and *The Catholic Leader*.

THE HON CHERYL EDWARDES



The Hon Cheryl Edwardes is one of Western Australia's leading businesswomen and former senior Minister with extensive experience including Attorney-General, Minister for the Environment and Minister for Labour Relations. Ms Edwardes is currently Chairman of Energy and Minerals Australia. She has also recently held the role of Executive General Manager for External Affairs for Hancock Prospecting and was a Special Counsel at Minter Ellison in Perth where she practised in government relations, climate change, environmental regulation and environmental compliance.

DR DOUG MCTAGGART



Dr McTaggart has held various senior positions in the private and public sectors including as Secretary of the Queensland Department of Treasury. He was a member of the COAG Reform Council and has held academic positions at Bond University. Dr McTaggart was until recently the Chairman of the Queensland Public Service Commission Board and a Commissioner on the Queensland Independent Commission of Audit. He was a Chief Executive of Queensland Investment Corp for 14 years and sits on a number of boards and has held positions on various industry bodies and public interest groups.

THE HON ALAN STOCKDALE



Mr Stockdale has extensive public and private sector experience. He was Treasurer in the Victorian Government from 1992 to 1999 and Federal President of the Liberal Party from 2008 to 2014. Mr Stockdale's private sector experience includes six years with Macquarie Bank. He has held a number of corporate advisory roles and has been chair or director of a number of voluntary and community organisations.

MS JENNIFER WESTACOTT



Ms Westacott is currently the Chief Executive at the Business Council of Australia (BCA) and has significant policy experience in both the public and private sectors. Prior to her role at BCA, she was a Board Director and lead partner at KPMG, heading its Sustainability, Climate Change and Water practice, and its NSW State Government practice. Ms Westacott also has extensive experience in leadership positions in the NSW and Victorian Governments.