Fit for purpose: a federation that guarantees the services people need

A framework for reform from ACOSS and State and Territory Councils of Social Service

Summary

This statement outlines a set of principles for reform of Commonwealth-State financial relations and taxation to improve essential community services (health, education and welfare services). It has been prepared by ACOSS and State and Territory Councils of Social Service.

Objective

We begin with a simple objective: that Commonwealth, State and Territory Governments should ensure the community receives essential community services (including health, education and welfare services) regardless of income and location. This includes services such as primary health care that should be available on a universal basis, and others such as affordable housing that should be targeted according to people's needs and resources.

Challenge

Commonwealth and State/Territory budgets are coming under pressure from the population ageing, growing health care costs and the need to address serious gaps in services such as mental and dental health, disability, schools, and affordable housing.

As public budgets face growing strain, services are being withdrawn and user charges are increasing. The Commonwealth is retreating from commitments to fund essential community services such as health care and schools, shifting the cost to States and Territories. The States and Territories, lacking strong revenue bases of their own, are in turn likely to pass the costs on to consumers.

Despite these challenges, governments have been reluctant to acknowledge the obvious: as well as improving the cost effectiveness of services such as health care, more revenue is needed to meet community expectations. Recently this silence was broken when State Premiers advocated increases in either the Medicare Levy or GST to meet rising costs in health care. The discussion was then side-tracked into a debate over whether the GST should be increased to pay for income tax cuts. This would shift taxes from higher income earners to the rest of us, without solving the funding shortages in community services.

The way forward

To meet the above objective, we need to find a more efficient way to share responsibilities between governments, underpinned by robust funding sources. More revenue will also be needed along with improvements to the cost-effectiveness of services such as health care.

i. Community service guarantees

The starting point should be to clearly define the core areas of responsibility for the Commonwealth and States/Territories, together with areas of shared responsibility.

The core governing principle for *major programs in areas of shared responsibility* (such as health care) should be for both levels of government to commit to ***'community service guarantees'*** to ensure universal access to affordable essential community services for all, regardless of people's incomes and where they live. These service guarantees would be jointly legislated, and include minimum standards for service provision or *'service entitlements'*. This statement outlines a proposed 'division of labour' between levels of government in implementing service guarantees.

ii. Strengthening revenue bases to provide essential community services

We will need coordinated tax reform – with both Commonwealth and State and Territory taxes reformed together in conjunction with the development of 'service guarantees' – to ensure that both levels of government have the revenues needed to fund essential community services into the future.

To achieve this for the long-term, all options have to be put on the table, and priority given to changes that improve the fairness and efficiency of the overall tax system. The first place to start is income tax shelters that are no longer fit for purpose, including superannuation tax breaks in the 'retirement phase', capital gains tax breaks and negative gearing, and private trusts and companies. Proposals to raise the GST or other regressive taxes should only be considered after those options are fully explored. The overall effect of changes to the tax system should be progressive *before* compensation is considered.

Principles for good governance of services across the Federation through 'community service guarantees'

In a federation, there will always be a need to share responsibilities for services between governments.

One reason for this is that universal and equitable access to major programs across the country cannot be guaranteed in a system where responsibilities sit solely with States and Territories. In addition, these governments lack robust revenue bases to finance services in areas of large and growing expenses such as health. Even if this problem was addressed, there is a risk that in a fully decentralised model, destructive tax competition would undermine the capacity of individual States/Territories to finance essential community services. This is especially so in those with the weakest revenue bases and populations with greatest need for services (for example, those with older or more disadvantaged populations).

The other reason for shared responsibilities is that the Commonwealth Government is usually too far removed from the ground, and lacks the expertise, to manage service delivery directly. On the other hand, the Commonwealth does have expertise in managing entitlements – ranging from social security to Medicare.

Many programs logically 'belong' with either the Commonwealth or the States and Territories. A good starting point for federation reform would be to clearly define these 'core' areas of sole responsibility. In other areas where shared responsibility is the best option, we propose that 'community service guarantees' be jointly legislated. Broadly speaking, in these areas the Commonwealth's role would be to define and guarantee national service entitlements and outcomes while the States and Territories would take responsibility for policy and administration of programs that deliver those entitlements.

Services would be provided 'on the ground' by a mix of government and non-government agencies and the optimal mix will vary across different programs. 'Market based' models such as competitive tenders for the provision of services or 'voucher' systems where consumers are subsidised to purchase their own services have a role to play but it should not be assumed that they are the most cost effective approach to delivering community service guarantees; or that private providers are more efficient than public ones. Competitive tenders for employment services for unemployed people that include for-profit providers have led to standardised services that fail to meet complex needs and engage with employers, while a 'voucher' scheme for the funding of vocational education and training entitlements in Victoria led to 'gaming' of the system by for-profit providers offering poor quality services, and wastage of public funds. 'Market based' systems can also undermine the diversity of services, and community engagement and control.

Objective

1. Commonwealth and State and Territory Governments should ensure the community receives the essential services it needs regardless of income and location.[1] These services come in two forms:

(1) *Universal services* are essential community services required by people generally at some stage of their lives.
Everyone who needs these services should have access to them when they need them through a 'common door' to a single system of services, whether government is the service provider or a 'mixed provider' model applies.
While consumer contributions are a feature of some existing universal service systems, a key aim is to prevent *fragmentation* of programs needed by everyone, where those who are well off receive support through one system (usually private, and fee-for service or insurance-based) and those with limited resources receive assistance through a separate system (usually publicly provided and means tested). Examples of fragmentation include dental care and the present (pre-NDIS) system of disability services. Service fragmentation disadvantages those with the least resources and greatest need, who are often the same people.

(2) *Targeted services* are essential community services required by *a minority of people with specific needs* (such as affordable housing).
These should be targeted to need, provide the required form and intensity of assistance, and be as accessible and stigma-free as universal services. They may, where appropriate, be means tested. Within targeted services, a distinction would be made between 'secondary services' for people with mild or moderate concerns and 'tertiary services' those with chronic, complex, or severe problems. The intensity of services varies according to the level of vulnerability services are responding to. All are embedded in a universal platform, with all tiers of the system working together.[2]

Core and shared responsibilities

2. A division of labour should be agreed between the three levels of government in which programs are divided broadly into three categories:
i) core Commonwealth responsibilities,
ii) core State/Territory responsibilities,
iii) core Local Government responsibilities, and
iii) shared responsibilities

The remainder of these principles apply to shared responsibilities.

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[1] Local Government is included in this framework by implication. Its role in regard to that of Commonwealth and State Governments is similar to that of the States vis a vis the Commonwealth. See 'division of responsibilities'
[2] Victorian Council of Social Service (2015): *Building on the value of Victoria's community sector* http://vcoss.org.au/documents/2015/06/Building-on-the-value-of-Victorias-community-sector_ONLINE-VERSION.pdf

This division would be based on whether national oversight and funding is needed to ensure that people receive essential community services regardless of where they live, and whether the Commonwealth or States and Territories are best placed to administer the program. For example, on this basis, affordable housing should be a shared responsibility. A Commonwealth retreat from this area would jeopardise essential supports for people who are insecurely housed.

Community service guarantees

3. The core governing principle in major programs where responsibility is shared between governments would be for both levels of government to commit to '*community service guarantees'* to ensure universal access (as defined above) to affordable essential community services for all, regardless of their incomes and where they live.

4. Community service guarantees would be jointly legislated by Commonwealth and State/Territory Governments.
   They would apply to major programs providing essential community services in areas of shared responsibility (such as health care), not necessarily all community services programs.

5. The guarantees would include minimum standards for service provision - '*service entitlements'* - and agreed service outcomes where appropriate.

   The service guarantees could replace major 'tied grants' to the States (such as the National Agreements pursuant to the 'Intergovernmental Agreement on Federal Financial Relations') In areas of shared responsibility, both levels of government would contribute according to an agreed formula (e.g. 50:50 cost-sharing).

6. As far as possible, programs that are inter-dependent would be integrated and broad-banded into a single program to reduce duplication and cost shifting, and (more importantly) to ensure that each program's goals are met in a coherent way.
   In broad-banded programs, care should be taken to avoid a 'one size fits all' approach to services, to ensure that special needs are met, and that resources are not diverted from 'prevention' to 'cure'.

   An example is the current fragmentation of health care funding for people with a chronic illness into a series of programs based on 'transactions' (Medicare, hospitals, PBS), which discourages investment in primary care or prevention and encourages over-investment in acute care. These arrangements also encourage cost shifting between governments.

Division of responsibilities

7. In areas of shared responsibility where community service guarantees apply:
   (i) The main responsibility of the Commonwealth would be to administer and guarantee service entitlements including identification of target groups and core service inputs and outcomes pursuant to each service guarantee.
   (ii) The main responsibility of States/Territories would be to ensure the funding/delivery of community services in accordance with the guarantees, whether they provide services directly or fund services provided outside government, or by Local government.
   (iii) Local government would also partner with the Commonwealth and States and Territories in the administration of programs in areas of shared responsibility, were appropriate.
   (iv) Services would be provided 'on the ground' by a mix of public and non-government agencies which would vary across the different programs. There would be no presumption that private provision, or funding by open tender, is the most cost effective model.

Financing

8. The cost of essential community services would continue to be shared across the community, mainly through public revenues.
   This could take the form of general revenue raising through taxes, and/or universal 'social insurance' arrangements administered publicly. [3]

9. Costs would be contained by clearly defining service entitlements, outcomes, and target groups rather than excessive reliance on ''queuing'' or user charges.
   Arbitrary caps on the resources available for essential services should be avoided: they are unfair and counterproductive, as the experience with disability services pre-NDIS shows. It is only by clearly defining the purpose, target groups, and service entitlements and outcomes that costs can be contained in an efficient and equitable way.
   User charges should play, at most, a modest role where appropriate to a given program: They already play a relatively large role in the financing of essential community services in Australia. If user charges were expanded further, universal services would become fragmented and people with limited resources would be excluded, or receive inferior services.
   An over-reliance on user charges or private insurance is not cost effective in any event, as experience with health care in the United States shows.[4]

Supporting reforms to the tax system

Public revenue must be strengthened to meet future costs for essential community services.[5] While there is scope to redesign public programs to improve their cost effectiveness (for example, a shift in health funding from acute care to prevention and promotion), population ageing together with new technologies and increasing (reasonable) community expectations in health and aged care mean that costs of essential community services will inevitably rise over time as a proportion of GDP. Remaining gaps in services (including disability services, schools, mental health and dental health, and services for Aboriginal and Torres Strait Islander peoples) must also be closed.

In reforming the tax system to strengthen public revenue, priority should be given to changes that improve the fairness and efficiency of the overall tax system, especially reform of income tax shelters that are no longer fit for purpose and disproportionately benefit higher income households. For example, as ACOSS' submission to the government's tax review on retirement incomes pointed out, there is scope to strengthen the personal income tax system for people of mature age to help fund health and aged care services as the population ages. Currently less than one in five people over 64 years pays income tax, due in large part to poorly designed superannuation tax concessions and tax offsets for seniors.[6]

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[3] Note that Australia lacks a strong social insurance tradition, and it is doubtful if a social insurance model would work better in areas of core Commonwealth responsibility such as social security.

[4] Due to large public subsidies for private health insurance and care, US Governments spends twice as much (16% of GDP compared with 8%) on health care as Australia, with poorer public health outcomes.

[5] Our broader goals and priorities for tax reform are outlined in ACOSS (2015): *Tax Talks 3: Rethink, re-engage, re-design* http://bit.ly/1MQT0zd

[6] ACOSS (2015): *Tax Talks 4: Three foundations for a secure retirement.* http://bit.ly/1KltLyE

While we believe Australia's public budget problems require us to keep all options for tax reform on the table, a large increase in a regressive tax such as the GST is not the best policy choice for strengthening public revenues to finance community services.

1. **Tax reform to strengthen public revenue should be linked to legislated service guarantees.**

A key argument raised in support of the introduction of the GST in 2000 was to strengthen State and Territory government revenues to fund essential services. ACOSS argued at the time that if a GST was introduced, the revenue should be assigned to States and Territories for that purpose. This was implemented, but the link between the new revenue source and community services expenditure was not backed by legislation. This raises the risk that instead of funding services, GST revenue could be used to finance 'destructive tax competition' (for example higher Payroll Tax thresholds).

Revenue increases to help finance essential services (such as health care) should be linked legislatively with community service guarantees:

- As a first step, any increase in Commonwealth revenues to fund essential community services in areas of shared responsibility should be linked to legislative guarantees of Commonwealth funding to State and Territories (for example, to restore realistic indexation of health funding).

One option is to earmark tax revenues to expenditure in community services, for example:

Revenue from the Medicare Levy, together with revenues from the reforms to the tax treatment of superannuation for people over 55 years old (outlined below), would be earmarked to future health care and NDIS services. This ensures a good fit between future growth in spending and revenues as the population ages.

- A link between health service guarantees and tighter tax treatment of superannuation in retirement (for those who can afford to pay) is a fairer and more acceptable alternative to higher user charges or increases in regressive taxes to fund health care.

'Earmarking' is not the same as hypothecation. The strict hypothecation of revenues for specific spending programs should be avoided as it would introduce too much rigidity into public budgets.

2. **Tax reforms to strengthen public revenue should maintain the overall progressivity of the tax system**

This is consistent with the goal that people should pay for services according to their capacity.

Since the main progressive element of the tax system is the personal income tax, first priority should be given to strengthening that tax base. This does not mean tax rates have to rise. It is more efficient to remove income tax shelters, so that more revenue can be raised with the same or lower tax rates.

Options include:

- Extending the 15% tax rate for superannuation fund earnings to accounts in the 'retirement phase'' which are currently exempt from tax, offset by a 15% rebate for individuals below the tax free threshold.[7]
- Restricting the Seniors and Pensioners Tax Offset to pension recipients.

[7] This option is detailed in ACOSS (2015): *ibid.* Note that it not the same as reintroducing taxes on superannuation benefits (lump sum payments or pensions).

- Extending the Medicare Levy to tax-sheltered income (such as the currently income tax-exempt or ''discounted'' portion of capital gains as well as personal income sheltered in private discretionary trusts and companies).[8]
- Replacing deductions for negatively geared investments in property and shares with a more efficient and less costly tax incentive for affordable rental housing.
- Removing the tax advantages associated with diverting personal income into private trusts and companies.

Reform of personal income tax and other progressive taxes (including Land Tax) should be pursued first before consideration is given to increasing regressive taxes such as the GST to finance community services. Increases in taxes on consumption should not be pursued without equivalent increases in income tax revenues, so that the overall progressivity of the system is maintained.

While we doubt that there is room in the Budget to cut personal income tax, any tax reductions should be paid for by closing tax shelters rather than increasing taxes such as the GST.

3. Tax reforms to strengthen public revenue should minimise harm to the economy, growth and jobs

This is best achieved by ''broadening'' tax bases so that income and other economic activities are taxed more consistently, provided equity is not jeopardised. Options include the above proposals to strengthen personal income tax, and:

- Extending Land Tax to owner-occupied properties, either integrated with or replacing Stamp Duties for property transactions.
- Broadening the base of Payroll Taxes.
- Replacing inefficient State taxes such as insurance taxes with more efficient ones.

As modelling by the Treasury for the Government's Tax Discussion Paper shows, there is little or no economic benefit from replacing taxes on earnings from work with taxes on consumption.[9] Reform should be built on facts and evidence, not tax myths.

Some inconsistencies in tax bases such as the GST exemption for fresh food have important equity purposes (discussed below), and should be retained.

4. Tax reforms to strengthen public revenue should not reduce the living standards of people on low incomes.

While personal income tax has little impact on low income households, taxes on consumption and other indirect taxes (for example insurance taxes and Stamp Duties) raise more revenue per dollar of income from low income households than high income earners:

- The lowest 20% pays on average 3% of their income in income tax, while the highest 20% pays an average of 20%.
- The lowest 20% pays on average 21% of their income in GST and other 'índirect' taxes while the highest 20% pays an average of 8%.[10]

This means that any increase in indirect or consumption taxes will disproportionately affect low income households, especially if exemptions from the GST are removed:

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[8] This is not the same as increasing the *rate* of the Medicare Levy.

[9] Australian Government 2015, ''Tax discussion paper', p25.

[10] ACOSS (2015), 'Paying our fair share'. Derived from published ABS income and expenditure data for 2012.

- The bottom 20% spends 19% of its income on food, compared with 15% for the top 20%.

The best way to protect the living standards of people on low incomes is to avoid large increases in regressive taxes such as the GST or user charges for essential services:

- ''Compensation'' for large increases in regressive taxes and charges is costly, and shifts the risk of reform to people on low incomes.
- Compensation is risky for people on low incomes because social security payments are always vulnerable to erosion through future Budget cuts:
    - Since the introduction of the GST in 2000, the real incomes of whole groups of vulnerable people have been reduced, for example, by shifting large numbers of single parents and people with disability off pension payments to the much lower unemployment payment;
    - The 2014 budget included proposals to cut benefits for young people, low income families and retirees.
- Compensation is also costly because large numbers of low income households are affected. For example, the increase in the income tax free threshold and social security payments to compensate low and middle-income households for the carbon price introduced in 2011 used up almost two thirds of the public revenue from polluter charges, even though the only income tax reduction in that package was an increase in the tax free threshold.

5. STATES AND TERRITORIES SHOULD HAVE ACCESS TO ROBUST, FAIR AND EFFICIENT TAX BASES TO FUND THEIR CORE SERVICES

Prior to the GST arrangements introduced in 2000, States and Territories relied heavily on untied Commonwealth grants to fund their core services. Premiers and Chief Ministers were advised of the Commonwealth's offer of untied grants for the forthcoming year the night before annual 'Premier's Conferences'. This made it difficult for them to plan for services over the longer term and defined their role as fiscal 'supplicants'.

The GST arrangements offered them more financial certainty since the assignment of 100% of revenues from a Commonwealth tax is more difficult to withdraw or alter than annual grants. However, States and Territories still lack fair, efficient and robust tax bases of their own and proposals to increase the GST raise major equity concerns.

Assigning States and Territories a fixed share of other Commonwealth tax revenues (for example income tax) does not necessarily provide certainty for States and Territories as the revenue-sharing formula could be altered from year to year.

Assigning States and Territories the right to levy additional income taxes off the Commonwealth's personal income tax base carries the same risk of destructive tax competition that ended Estate taxes and undermined Payroll taxes. Income is relatively mobile and not well suited to taxation at the State level.

Coordinated tax reform - where both Commonwealth and State and Territory taxes are reformed together in conjunction with 'service guarantees' - has potential to limit destructive tax competition without undermining the fiscal sovereignty of States and Territories.

One option within this framework is for the Commonwealth to raise revenue from mobile tax bases such as payrolls on behalf of States and Territories off a standard national tax base, as is the case already with the GST. This would also bring efficiency gains, especially for businesses operating across State and Territory boundaries.