

Department of Finance

Submission to the Productivity Commission Review of Natural Disaster Funding Arrangements

June 2014

Introduction

A key role of the Department of Finance (Finance) is to assist in improving the effectiveness of government spending. Reflecting this role, the Finance Secretary, Mr David Tune, is a member of the Commonwealth's Reconstruction Inspectorate.

2. The other members of the Inspectorate are providing a separate submission.
3. In practice, funding for road works has become by far the largest component of Natural Disaster Relief and Recovery Arrangements (NDRRA) expenditure. Accordingly, this submission focuses on road funding provided under the provisions for the restoration of essential public works (under Category B of the NDRRA), including the impact on cost-effective decision making.
4. The relevant context is:
 - a) For the period 2010-11 to 2015-16, the current estimate of Commonwealth payments under the NDRRA is \$11.5 billion (which on average is \$1.9 billion per annum). For the ten years prior to 2010-11, expenditure averaged under \$100 million per annum, with only one year (2008-09) exceeding \$200 million¹. The increase in recent years largely relates to natural disasters in Queensland.
 - b) Around 90 per cent of NDRRA funding in recent years has been for the restoration of essential public assets under Category B. Most of this is for road works (generally relating to work undertaken in the two years following the event)². The available data indicates that road funding accounted for a much lower percentage of NDRRA funding in the years before 2010-11.³
 - c) The Category B assistance under the NDRRA is intended to reduce the fiscal burden on a state from replacing/repairing essential public assets following natural

¹ Commonwealth Budget Papers and Final Budget Outcomes.

² Source: Emergency Management Australia data.

³ Source: Department of Finance and Deregulation - *Review of Insurance Arrangements of State and Territory Governments under the Natural Disaster Relief and Recovery Arrangements Determination 2011 Phase 1 Report* – March 2012 (Appendices).

disasters, in conjunction with state measures including insurance and disaster mitigation planning and implementation.

- d) Under Category B, the Commonwealth provides up to 75 per cent of the cost of restoration or replacement of state and local government essential public assets directly damaged by natural disasters. This includes roads that the state has assessed to be a necessary and integral part of the state's infrastructure, which if lost would severely disrupt the normal functioning of a community.
- e) The 75 per cent Commonwealth contribution applies after eligible state expenditure on natural disasters for the financial year exceeds around 0.4 per cent of the state's total general government revenue and grants received. (Eligible expenditure includes state expenditure on a natural disaster in excess of \$240,000.)
- f) Since 2007, the NDRRA have included a provision for betterment funding (to restore an essential public asset, damaged by a natural disaster, to a more disaster-resilient standard than its pre-disaster condition). The Commonwealth may reimburse up to one third of the betterment costs associated with restoring or replacing a local government owned asset, or up to 50 per cent of the betterment costs for restoring or replacing a state owned asset. This provision has been little used. In contrast, a joint Commonwealth-Queensland \$80 million betterment fund has received a high level of applications.
- g) While state governments have put in place insurance arrangements, including self-insurance arrangements, for a range of public assets, these arrangements have generally not been extended to roads. In particular, Queensland does not insure roads. Conventional private sector insurance cover for roads appears difficult or impossible to obtain in some cases, but it is unclear what state self-insurance arrangements would have applied in the absence of the NDRRA.

Implications for cost effective decision-making and resource allocation

5. In general, states and local governments are responsible for expenditure decisions on roads, including matters such as engineering standards, road maintenance and addressing disaster resilience requirements. These can be seen as matters that, as far as practicable, are best left to the relevant level of government, which would be best placed to assess priorities, asset conditions and risks at the state and local level.

6. When the NDRRA Category B provisions are triggered, the Commonwealth provides up to 75 per cent of state and local government costs of restoring the assets to the pre-disaster condition.

7. Accordingly, there is a major difference between (a) the normal funding, decision making and accountability for state and local government roads and (b) funding responsibility following a natural disaster.

8. This changes the financial costs/benefits relationship for state and local government decision making on road expenditure and may lead to under-investment in mitigation of disaster risks (for instance, through the choice of construction techniques or the location of roads). The arrangements could also create a disincentive for further consideration of non-conventional insurance or self-insurance for roads affected by disaster events. In areas where Category B declarations are relatively frequent, it would also change the risk/reward structure between regular road maintenance expenditure and expenditure following a disaster declaration.

9. Overall, the gaps between costs and benefits for decision makers could be expected to have a negative impact on resource allocation. It does not appear possible to quantify these impacts. However, the response to NDRRA betterment provisions may provide an illustration of how alternative incentives affect behaviour.

10. As noted above, the Commonwealth may reimburse up to one third of the betterment costs associated with restoring or replacing a local government owned asset, or up to 50 per cent of the betterment costs for restoring or replacing a state owned asset. A requirement is that a more disaster-resilient standard be achieved than pre-disaster. However, these provisions have been little used. On the face of it, this suggests that the arrangements create a strong incentive to undertake activities on which 75 per cent Commonwealth funding is claimed, even if the better long term alternative option is expenditure on more disaster-resilient assets but which attracts a substantial but lower level of Commonwealth contribution.

11. This contrasts to the experience with \$80 million Betterment Fund, jointly established by the Commonwealth and Queensland Governments in February 2013. Under this Fund, local governments could apply for grants of up to \$2 million for betterment projects. Local government contributions were considered to enhance applications but were not required. Expressions of interest for funding were received from local governments for more than \$1 billion worth of betterment projects. Most of the Betterment Fund has now been allocated. The differences from the NDRRA betterment provisions include that the Betterment Fund could be applied for at any time, rather than after an eligible disaster, and the Commonwealth is providing a greater share of the funding.

Budget Allocation Issues

12. Given the uncertainties involved in making reasonable estimates of the amounts of funding for future disaster, the Commonwealth does not make provision in its estimates for future disasters, only for those that have occurred.

13. After an event has occurred, the Commonwealth has no effective control over the level of eligible Category B expenditure that occurs (and there may also be significant changes in timing of payments compared to initial estimates). As a result, NDRRA expenditure is not weighed against competing expenditure priorities through normal budget processes. However, once events have occurred and the Commonwealth commitments estimated, there is reduced scope for other Commonwealth expenditure within given fiscal constraints.

Compliance issues

14. As Category B funding is tied to eligible expenditure on individual road projects, the current arrangements require the Commonwealth to have a detailed interest in how the states and local governments undertake the relevant road projects.

15. This includes assessments of whether damage is due to the relevant weather event or was pre-existing, whether the expenditure is value for money (for example could more cost effective construction methods be used), has the work been undertaken using external suppliers or in-house works capacity (and if the latter, what are the internal costing and charging processes), and is the expenditure only restoring an asset to the pre-existing level of utility.

16. The Commonwealth has developed additional processes for assessing these issues, and substantial savings have been achieved compared to original funding requests. However, there are significant practical issues in providing ongoing assurance under the existing arrangements, given the level of detail required and the volume of work at current levels. For example, there are around 1,500 individual projects for Queensland 2010-11 disaster events alone.

17. These issues, together with primary responsibility for the assets resting within state and local governments, raise the question as to whether a simpler funding mechanism, less reliant on detailed Commonwealth involvement, should be preferred.

Policy Options

18. The National Commission of Audit set out policy alternatives for future NDRRA funding. Changes discussed included:

- a) reducing the level of Commonwealth Category B contribution as a percentage of the estimated reconstruction costs, to assist in addressing the impact on cost effective decision making; and
- b) the Commonwealth contribution (as the relevant percentage of the likely cost of replacing essential public assets) being based on an upfront assessment by independent assessors. This would remove the need for detailed project-by-project expenditure acquittal.

19. Another alternative discussed was raising the thresholds for state expenditure required for NDRRA Category B assistance. This would more closely align decision making and responsibility for funding, in circumstances where the fiscal impacts were limited.

20. In the context of the Commonwealth's contribution being set by an upfront assessment, the states could have flexibility as to how the funds were spent (for instance, on whether the funds were used for like-for-like reconstruction or for improving assets). This would allow states to determine the most efficient allocation of the available funding.

21. Given the significance of roads in NDRRA funding and the issues identified above, one alternative would be to make changes only to how the arrangements apply to road funding.