PARLIAMENT OF VICTORIA

LEGISLATIVE ASSEMBLY
Economy and Infrastructure Committee

Inquiry into Commonwealth support for Victoria

Parliament of Victoria
Legislative Assembly Economy and Infrastructure Committee

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Functions

The Economy and Infrastructure Standing Committee is established under the Legislative Assembly Standing Orders Chapter 24—Committees.

The Committee's functions are to inquire into and report on any proposal, matter or thing connected with the following departments and their related agencies:

- Department of Education and Training
- Department of Jobs, Precincts and Regions
- Department of Transport
- Department of Treasury and Finance.

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This report is available on the Committee's website.

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Terms of reference

Inquiry into Commonwealth support for Victoria

On 4 August 2021 the Legislative Assembly agreed to the following motion:

That this House refers:

an inquiry into Commonwealth support for Victoria to the Economy and Infrastructure Standing Committee for consideration and report no later than 30 March 2022 and the Committee should consider various issues associated with the inadequacy of Commonwealth support for Victoria, including, but not limited to:

(a) Victoria's share of federal GST funding; and

(b) the expiration of the 'no worse off' GST guarantee.

Chair’s foreword

This report makes it patently clear that Victoria is not getting its fair share of GST revenue and other funding from the Australian Government. As a Victorian, I’m annoyed and quite frankly offended that we are being duded out of millions of dollars of federal funding each year, significantly reducing the capacity of current and future Victorian governments to provide vital infrastructure and services, including health and education. Further, Victoria has borne the brunt of the COVID-19 pandemic, with high case numbers and lengthy lockdowns having severe and long-term social and economic impacts. Significant additional Commonwealth support is urgently needed to assist the state’s recovery to ensure that Victoria and all Victorians can thrive now and into the future.

This report and its findings and recommendation are an urgent call for action. It is time for the government and all Victorians to stand up and demand a fair go for our state and it is time for the Australian Government to fairly support Victoria’s growth and prosperity.

The way GST revenue is distributed between the states and territories has always been contentious as each jurisdiction wants the best fiscal result for its people. Victoria’s concerns have only grown following recent Commonwealth reforms to GST distribution, which take effect in 2021–22. The reforms create an inequitable outcome that will leave all states and territories other than Western Australia financially disadvantaged.

Since the mining boom, Western Australia has received a GST revenue share much lower than its population share due to the billions of dollars it receives each year in mining royalty payments. The GST distribution reforms effectively set a limit on how low any state or territory’s GST revenue share can drop. For the foreseeable future, this floor will only apply to Western Australia, which will reap a greater share of GST revenue on top of its mining revenue.

Despite the other states and territories successfully demanding a no-worse-off guarantee that ensures they receive the amount of GST revenue based on the better of the old or new system, this guarantee only lasts until 2026–27. After that, Victoria and the other states and territories will no longer be insulated from the effects of these reforms and will be financing Western Australia’s increased GST share. Revenue losses for Victoria are predicted to be around $1 billion in 2027–28 alone.

Western Australia’s unfair advantage will result in other states and territories having to adapt to the loss of billions of dollars of revenue by cutting public services, imposing higher state taxes and/or incurring more debt. At the same time, Western Australia is the only Australian jurisdiction reporting a budget surplus and is projected to continue having surpluses over the coming years.

The Commonwealth's reforms to GST distribution must be reversed. At the very least the no-worse-off guarantee must be continued beyond 2026–27 until the inequity caused by the reforms is addressed. Without any change, future Victorian governments will be unable to plan for and provide an adequate level of public services for Victorians.

During the Inquiry, the Committee also heard that the level of Commonwealth investment in Victorian infrastructure is significantly below its population share and this pattern is projected to continue. There needs to be more transparency around the Commonwealth's infrastructure funding decisions and greater collaboration between the Victorian and Australian governments on infrastructure priorities.

The Commonwealth should also provide more financial assistance to local government in Victoria and more funding and collaboration for Victoria's pandemic recovery efforts, which were two other areas stakeholders raised as receiving inadequate Commonwealth support.

The Committee sincerely appreciates the time and effort of the individuals and organisations who wrote submissions and attended public hearings to share their views and expertise with the Committee.

I thank the Deputy Chair, Mr Gary Blackwood MP, and my fellow Committee Members for their contributions and commitment to the Inquiry. On behalf of the Committee, I also extend our gratitude to the Secretariat for their continued hard work and support.

Hon John Eren MP
Chair

Executive summary

Commonwealth reforms to how Goods and Services Tax (GST) revenue is distributed to the states and territories came into effect in 2021–22. Once the changes are fully implemented in 2027–28, Victoria is expected to lose significant amounts of GST revenue. Until then, states and territories (hereafter states) are shielded from the effects of the reforms by a no-worse-off guarantee that ensures states receive GST revenue based on the better of the old or new system.

This Inquiry's terms of reference asked the Legislative Assembly's Economy and Infrastructure Committee to examine the adequacy of Commonwealth support for Victoria, specifically Victoria's GST share and the impact of the end of the no-worse-off guarantee. The Committee also chose to consider the levels of Commonwealth investment in Victorian infrastructure, Commonwealth assistance to local government and Commonwealth support for Victoria's recovery from the effects of the COVID-19 pandemic.

GST revenue distribution is based on the principle of horizontal fiscal equalisation

Horizontal fiscal equalisation (HFE) aims to ensure Australians have access to similar levels of government services and infrastructure irrespective of which state they live in. When GST revenue is distributed between the states, HFE equalises for differences in states' capacities to raise revenue and the costs they incur to deliver services and infrastructure. These differences can arise from economic, social and demographic factors, such as mining production, property sales, remoteness, Indigenous status, population growth and natural disasters. Under full equalisation, states that have an excellent capacity to raise revenue, such as Western Australia (WA) through mining royalty payments, receive a lower share of GST revenue relative to their population. States' GST revenue shares are based on their fiscal capacities and GST relativities, which are calculated by the Commonwealth Grants Commission.

The GST distribution reforms create new equalisation arrangements

In 2018, the Australian Parliament passed legislation to reform GST revenue distribution following a Productivity Commission (PC) inquiry into HFE. The then Australian Treasurer referred the inquiry to the PC in response to WA's concerns that its GST share had fallen to a record low as a result of the mining boom. The legislation, which did not fully reflect the PC's recommendations, resulted in:

- the introduction of a minimum GST relativity (relativity floor) of 0.7, which will increase to 0.75 in 2024–25

- a permanent boost to the national GST pool from the Commonwealth
- new equalisation arrangements, where equalisation is based on the fiscal capacity of the stronger of New South Wales (NSW) and Victoria (rather than of the strongest state as before).

The reforms will be introduced over a transition period from 2021–22 to 2026–27. During this time, a no-worse-off guarantee ensures no state is disadvantaged from the shift to the new system.

Most states will lose GST revenue due to the reforms

Under the new equalisation arrangements, the only state that is likely to trigger the relativity floor is WA due to its strong fiscal capacity. When WA's GST relativity is lifted to the floor, every other state's relativity, and consequently their share of GST revenue, will fall to compensate. When the no-worse-off guarantee applies, the other states are insulated from the effects of these arrangements on their GST revenue. However, from 2027–28, the other states are set to lose billions of dollars according to modelling by various state treasury departments.

For example, the Victorian Department of Treasury and Finance predicts Victoria will lose between $87 million and $1.2 billion in 2027–28 alone. The impact of this revenue loss on Victoria and states other than WA is expected to affect their ability to provide adequate public services and infrastructure. These states will have to either provide fewer or poorer quality services, impose higher or new state taxes and/or incur more debt.

The reforms undermine the intent of horizontal fiscal equalisation

The former equalisation arrangements achieved full fiscal equalisation between Australia's states. However, the new equalisation arrangements mean that any state that has a stronger fiscal capacity than the stronger of NSW and Victoria will have the advantage of gaining a greater share of GST revenue than it would have had otherwise. Full fiscal equalisation is only possible if equalisation is based on the fiscal capacity of the strongest state. Since WA has been the fiscally strongest state for most of the past fifteen years and is predicted to remain so for the foreseeable future, the new arrangements are unable to achieve full fiscal equalisation and will undermine the intent of HFE.

Fiscally weaker states argue HFE is essential to offset geographic and demographic differences that make revenue raising harder and/or service provision more expensive for them. However, fiscally stronger states are often aggrieved that they receive less than their population share of GST revenue. Critics of HFE also argue that HFE acts as a disincentive for fiscally weaker state governments to reform their tax system or pursue other economic reforms because they would risk losing GST revenue. Previous inquiries into HFE, including the PC inquiry, did not find evidence that HFE has disincentivised states to pursue economic reforms. However, the PC argued that a theoretical disincentive exists, and it recommended new equalisation arrangements based on the average state fiscal capacity. Instead, the Australian Government chose to base the new arrangements on the fiscal capacity of the stronger of NSW and Victoria.

The reforms will create inequity between the states and cost more than forecast

The evidence received by the Committee overwhelmingly indicates that WA is the primary beneficiary of the new equalisation arrangements, even if mining production levels fall. This is despite WA recording a large budget surplus in 2020–21 and expecting future surpluses in the years to follow. With this increased revenue, WA will be able to provide more public services, impose lower taxes and repay its debts faster. When the no-worse-off guarantee ends, states other than WA will have to bear the cost of WA's increasing GST share. WA's ongoing gain and the other states' ongoing loss of GST revenue under the new equalisation arrangements will entrench inequity between the states.

When the Australian Government announced the GST distribution reforms it claimed all states would be better off, but this was based on assumptions that WA's GST relativity would rise. Large increases to iron ore prices since have resulted in WA's GST relativity falling significantly below the relativity floor. This has resulted in the Australian Government substantially underestimating the cost of the no-worse-off guarantee payments by billions of dollars.

The GST reforms must be reversed or the no-worse-off guarantee continued

Most stakeholders supported a return to the former equalisation arrangements. The Committee agrees that the Victorian Government should work with other states that are adversely affected to advocate that the Australian Government revert to the former equalisation arrangements for GST distribution. If the Australian Government will not reverse the reforms, the Committee recommends the Victorian and other state governments demand the extension of the no-worse-off guarantee beyond 2026–27 until the inequity created by the new equalisation arrangements is addressed. A legislated PC review of the new arrangements due in 2026 should also be brought forward and the states should be involved in developing the terms of reference of the review.

More Commonwealth support is needed for Victorian infrastructure, local government and pandemic recovery efforts

As well as concerns with the GST distribution reforms, stakeholders raised other areas where Commonwealth support to Victoria could be improved. The Committee heard that Victoria regularly receives significantly less than its population share of Commonwealth infrastructure investment and there is a lack of transparency around infrastructure funding decisions. The Victorian Government should drive greater collaboration between itself, the Australian Government and state and federal advisory bodies to ensure priorities for infrastructure investment are based on business cases showing the highest net public benefits.

The Committee also heard that councils in regional and rural Victoria rely heavily on Commonwealth Financial Assistance Grants to provide services and infrastructure due to higher delivery costs and lower capacities to raise revenue than metropolitan councils. A three-year indexation freeze on Financial Assistance Grants from 2014–15 has eroded the value of these grants and the Victorian Government should continue to seek greater Commonwealth support for local government to compensate. The Victorian Government should also pursue further Commonwealth support and collaboration to address the impact of the COVID-19 pandemic on the state's frontline services and businesses.

Findings

2 How the GST distribution reforms harm Victoria

3 How the Commonwealth could support Victoria better

Recommendations

RECOMMENDATION 7: That the Victorian Government continue to advocate that the Australian Government provide additional support to address the significant and ongoing negative impacts of the COVID-19 pandemic on Victoria's businesses, social service organisations and vulnerable populations as well as on the wellbeing of all Victorians.

Acronyms and terms

CGC	Commonwealth Grants Commission
COPE	Commonwealth Own Purpose Expenditure
DTF	Victorian Department of Treasury and Finance
GST	Goods and Services Tax
HFE	Horizontal fiscal equalisation
IGA	Intergovernmental agreement
IGA FFR	IGA on Federal Financial Relations
MAV	Municipal Association of Victoria
PC	Productivity Commission
VCOSS	Victorian Council of Social Service

Tables and figures

1 Introduction

Victoria risks losing significant levels of funding following recent legislative changes to how the Commonwealth distributes Goods and Services Tax (GST) revenue to states and territories. The revenue loss will impair the ability of current and future Victorian governments to plan and provide services for Victorians. These changes, which begin in 2021–22, will be phased in over a transition period until 2026–27. Until then, a no-worse-off guarantee will ensure states and territories receive GST revenue based on the better of the old or new system.

On 4 August 2021, the Legislative Assembly's Economy and Infrastructure Committee received terms of reference to conduct an inquiry into Commonwealth support for Victoria. The Committee was specifically asked to consider Victoria's share of GST revenue and the impact of the end of the no-worse-off guarantee.

In addition to considering the GST distribution changes, the Committee also considered the adequacy of other types of Commonwealth support for Victoria, specifically infrastructure investment, local government assistance and support for Victoria's recovery from the COVID-19 pandemic. The Committee consulted with economists, state and territory governments, research institutes and representatives from business, local government, social services and regional Victoria.

The evidence received by the Committee shows the new GST distribution arrangements pose a significant risk to Victoria's finances and Victoria is set to lose billions of dollars if the no-worse-off guarantee expires and the arrangements remain unchanged. If this occurs, the loss of revenue could force future Victorian governments to cut public services, impose new taxes and/or incur more debt.

This report makes a series of recommendations that aim to prevent the substantial GST revenue loss that Victoria and most other states and territories are facing in the medium to long term. It also makes recommendations to improve Commonwealth support for Victorian infrastructure, local government and pandemic recovery efforts.

1.1 The Commonwealth provides tied and untied grants to Victoria

Commonwealth grants to Australian state and territory (hereafter state) governments can be divided into tied and untied grants. Tied grants are grants for specific purposes such as delivering infrastructure or health, education and community services. Usually, the Commonwealth sets conditions on how the states can spend this money. General purpose grants, or untied grants, have no conditions and the Commonwealth has no direct say on how these funds are used.

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The Commonwealth provides tied and untied grants to state governments through the Federal Financial Relations system, which is governed by the *Federal Financial Relations Act 2009* (Cth). The Act appropriates funds to provide financial assistance to the states through:

- GST revenue, which states can use for any purpose
- national specific-purpose payments, which states can only use for service delivery in certain sectors
- national health reform payments, which states can only use in accordance with the National Health Reform Agreement
- payments relating to housing, homelessness and housing affordability matters, which states can only use in accordance with specified agreements
- national partnership payments, which states can only use to support the delivery of specified outputs or projects
- other general revenue assistance.[1]

As shown in Table 1.1, the Victorian Government expects to receive $36.8 billion in Commonwealth grants in 2021–22.

Table 1.1 Victorian Government grant revenue ($ million), 2020–21 to 2024–25

	2020–21 revised	2021–22 budget	2022–23 estimate	2023–24 estimate	2024–25 estimate
General purpose grants—GST	17,044	17,391	19,213	19,463	19,997
Grants for specific purposes	14,164	13,772	14,695	14,738	14,916
Specific-purpose grants for on-passing	4,184	4,838	5,092	5,370	5,730
Total	**35,392**	**36,001**	**39,001**	**39,571**	**40,643**
Other contributions and grants	351	777	695	956	877
Total grant revenue	**35,743**	**36,778**	**39,695**	**40,527**	**41,520**

Source: Victorian Department of Treasury and Finance, *Victorian Budget 2021–22 Paper No. 5: statement of finances*, Melbourne, 2021, p. 181.

1.1.1 GST revenue is Victoria's largest source of funding

Half of Victoria's revenue comes from the Commonwealth. Of all the different types of Commonwealth grants Victoria receives, GST revenue is the largest, as shown in Table 1.1. In 2021–22, Victoria is set to receive $17.4 billion in GST revenue. About 24% of Victoria's total revenue consists of GST grants, with the balance made up of tied grants

1 Council on Federal Financial Relations, *Legislative framework*, <https://federalfinancialrelations.gov.au/legislative-framework> accessed 5 January 2022.

from the Commonwealth, state taxation, sales of goods and services, interest, dividends and other revenue.[2]

The Commonwealth provides GST revenue to Victoria as an untied grant. The amount is determined by three factors:

- the amount of GST collected by the Commonwealth (known as the national GST pool)
- Victoria's GST relativity
- Victoria's proportion of the national population.

Victoria's GST relativity is determined by the Commonwealth Grants Commission (CGC), a statutory body that advises the Australian Government on financial assistance to the states. It does this by determining the relative fiscal capacity of each state, which in turn informs GST distribution based on the principle of horizontal fiscal equalisation (HFE), which is explained in the next section.

A state's relative fiscal capacity is a measure of the GST revenue it needs to provide the national average standard of services and infrastructure for its population assuming it makes the average effort to raise revenue and operates at the average level of efficiency.

A state's relative fiscal capacity is used to calculate its GST relativity, which is a per capita weight that determines GST share. It is an average of the state's calculated relativities for the last three completed financial years to avoid the influence of a single year on the upcoming year's calculation. A relativity below 1 indicates a state's fiscal capacity is above average, requiring less than its population share of GST to provide the average level of services. Victoria's GST relativity in 2021–22 is 0.92335.

GST revenue is distributed based on the principle of horizontal fiscal equalisation

HFE is designed to equalise states' revenue-raising abilities and expense burdens so they can provide similar levels of services and infrastructure. It aims to ensure Australians have access to similar levels of government services irrespective of the state they choose to live in.[3]

HFE distributes funding between jurisdictions to offset differences in:

- their capacity to raise revenue through taxes, royalties, fees, fines and dividends from government corporations
- the costs they incur to deliver services such as schools, healthcare, housing, roads and public transport.

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2 Victorian Department of Treasury and Finance, *Inquiry into Commonwealth support for Victoria: public hearing presentation*, supplementary evidence received 15 December 2021, p. 3.

3 Victorian Department of Treasury and Finance, *Submission 4*, pp. 2–3.

These differences occur due to economic, social and demographic factors, and they are influenced by mining production, property sales, taxable payrolls, remoteness, Indigenous status, population growth, community sizes, employee costs and natural disasters. Most federations have some form of HFE, and research prior to 2018 showed Australia's arrangements were considered the most comprehensive and the 'gold standard' internationally.[4]

Under full equalisation, states that have an excellent capacity to raise revenue, such as Western Australia through mining royalty payments, receive a lower share of GST relative to their population. Similarly, states that have lower expenditure requirements, such as Victoria due to its more compact size, smaller Indigenous population, fewer remote residents and smaller proportion of government school students, also receive below their per capita share.[5]

New equalisation arrangements came into force in 2021–22

The *Treasury Laws Amendment (Making Sure Every State and Territory Gets Their Fair Share of GST) Act 2018* (Cth) reformed how GST revenue is distributed to the states from 2021–22 onwards. The Australian Treasurer stated the former distribution system of full equalisation was not working as intended because Western Australia received '30 cents in the dollar, while other states and territories with far smaller populations received more.'[6]

The Act amended the *Commonwealth Grants Commission Act 1973* and the *Federal Financial Relations Act 2009* to:

- introduce a minimum GST revenue sharing relativity (relativity floor) of 0.7, which will increase to 0.75 by 2024–25
- permanently boost the national GST pool with Commonwealth financial assistance
- transition the HFE system from full equalisation to reasonable equalisation, where equalisation is based on the fiscal capacity of the stronger of New South Wales and Victoria.[7]

The shift to reasonable rather than full equalisation resulted in the CGC basing equalisation on states' ability to provide a 'reasonable standard' of services (based on the fiscal capacity of the stronger of New South Wales and Victoria) rather than the same standard of services (based on the fiscal capacity of the strongest state).

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4 Jonathan Coppel, 'The economic impacts of HFE: lessons from Australia', paper presented at 14th annual meeting of the OECD Network on Fiscal Relations Across Levels of Government, Paris, 19–20 November 2018, p. 3.

5 Mr Saul Eslake, Economist and Principal, Corinna Economic Advisory, *Submission 1*, p. 11.

6 Hon Josh Frydenberg, *New laws deliver a fairer and more sustainable GST system*, media release, Australian Government, Canberra, 13 November 2018.

7 Commonwealth Grants Commission, *About GST distribution*, <https://www.cgc.gov.au/about-gst-distribution> accessed 2 March 2022.

A transition period for the reforms will last from 2021–22 to 2026–27. During this period, states and territories will receive funding based on the better of the old or new system, referred to as the no-worse-off guarantee (explained in more detail below). At the end of the transition period, the Productivity Commission will conduct an inquiry to assess whether the new system is working efficiently, effectively and as intended.

Table 1.2 shows the GST relativities and shares of the national GST pool of each Australian state and territory under the old (2020–21) and new (2021–22) system.

Table 1.2 **GST relativities and GST pool shares of states and territories, 2020–21 and 2021–22**

	2020–21 relativity	2020–21 share (%)	2021–22 relativity	2021–22 share (%)	2021–22 population share (%)
Victoria	0.95992	25.1	0.92335	24.1	26.1
New South Wales	0.91808	29.2	0.95617	30.3	31.7
Queensland	1.04907	21.2	1.05918	21.5	20.3
Western Australia	0.44970	4.7	0.41967	4.3	10.4
South Australia	1.35765	9.4	1.34719	9.2	6.9
Tasmania	1.89742	4.0	1.96067	4.1	2.1
Australian Capital Territory	1.15112	1.9	1.16266	2.0	1.7
Northern Territory	4.76893	4.5	4.79985	4.4	0.9

Source: Adapted from Commonwealth Grants Commission, *Report on GST revenue sharing relativities 2021 update: GST revenue sharing relativities for 2021–22*, Canberra, 2021, p. xii.

The 2021–22 GST relativities were derived from the states' relative fiscal capacities, which were adjusted to ensure no state had a fiscal capacity below that of the stronger of New South Wales or Victoria. For two of the three reference years, the CGC deemed Victoria to have a stronger fiscal capacity than New South Wales due to Victoria's above average growth in property sales, below average expense requirements, and upward revisions to its taxable payrolls based on employee data from the Australian Bureau of Statistics.[8]

The adjusted fiscal capacities are referred to as the standard state capacities. The adjustments increased the GST share for states with a fiscal capacity above the standard state and decreased the GST share of all the other states, including the standard state.

As shown in Table 1.3, in 2021–22, GST relativities were calculated using five-sixths of a state's relative fiscal capacity (old system) and one-sixth of its standard state capacity (new system). This is referred to as the blended capacity. In 2022–23, the CGC will

8 Commonwealth Grants Commission, *Report on GST revenue sharing relativities 2021 update: GST revenue sharing relativities for 2021–22*, Canberra, 2021, pp. 3, 25.

calculate the blended capacities using four-sixths of the old system and two-sixths of the new system; in 2023–24, it will use three-sixths of the old system and three-sixths of the new system; and so on until full use of the new system in 2026–27.

Table 1.3 **Fiscal capacities and GST relativities of states and territories, 2021–22**

	Relative fiscal capacity	Standard state capacity	Blended capacity	Floor used	GST relativity
Victoria	0.93169	0.86976	0.92335	n/a	0.92335
New South Wales	0.96451	0.90258	0.95617	n/a	0.95617
Queensland	1.06753	1.00559	1.05918	n/a	1.05918
Western Australia	0.32852	0.86359	0.41967	n/a	0.41967
South Australia	1.35554	1.29360	1.34719	n/a	1.34719
Tasmania	1.96901	1.90707	1.96067	n/a	1.96067
Australian Capital Territory	1.17101	1.10907	1.16266	n/a	1.16266
Northern Territory	4.80820	4.74626	4.79985	n/a	4.79985

Note: n/a = not applicable.

Source: Adapted from Commonwealth Grants Commission, *Report on GST revenue sharing relativities 2021 update*, p. 3.

In 2021–22, the GST relativities are equal to the blended capacities. From 2022–23, the CGC will take the additional step of introducing a relativity floor to ensure no state's relativity is below 0.7. If the relativity floor needs to be used for a state, then the other states' relativities will fall to compensate, meaning their GST share will also fall.[9]

Prior to the introduction of the relativity floor, the Commonwealth will make supplementary payments to Western Australia to give it an equivalent outcome to a relativity of 0.7. Western Australia has received these payments for the last three years. These payments will be funded from the GST pool from 2022–23.[10]

To ease the transition to the new system, the Commonwealth is making additional payments into the national GST pool, which will grow the pool on a permanent basis. In 2021–22, the boost to the national GST pool will be $600 million (about 0.8% of the pool). The additional payment will be indexed annually and an additional $250 million will be added each year from 2024–25 onwards, when the relativity floor increases to 0.75.[11]

9 Ibid., p. 3.

10 Ibid., p. xi.

11 Commonwealth Grants Commission, *Submission on the draft report from the Commonwealth Grants Commission, submission to Productivity Commission*, Inquiry into horizontal fiscal equalisation, 2017, p. 18; Victorian Department of Treasury and Finance, *Victorian Budget 2021–22 Paper No. 5: statement of finances*, Melbourne, 2021, p. 184.

A no-worse-off guarantee is in place until 2026–27

In response to the new equalisation arrangements, the states successfully argued for the inclusion of a no-worse-off guarantee in the 2018 legislation. The guarantee ensures no state is disadvantaged from the shift to the new system by ensuring the GST revenue it receives is based on the better of the old or new system. It is legislated until 2026–27 when the transition period ends.

Prior to the reforms, a state's GST relativity was equal to its relative fiscal capacity. Therefore, a state's relative fiscal capacity is also referred to as its no-worse-off relativity. This is the relativity that the CGC will use during the transition period to determine if a state is worse off under the new system.

Without the guarantee, Victoria would have lost an extra $2.3 billion in GST revenue over the next four years according to the Victorian Department of Treasury and Finance (DTF). It added that many states, including Victoria, risk an ongoing loss of GST revenue after 2026–27 when the guarantee ends.[12]

The Victorian DTF modelled various scenarios such as weaker housing markets in New South Wales and Victoria, changes in iron ore prices, and similar economic conditions to those experienced over the past decade, to test the impact on GST relativities in 2027–28. Under every scenario, Victoria is expected to be worse off and in the worst-case scenario it stands to lose about $1.2 billion in 2027–28. DTF claimed the risk of losing significant GST revenue hinders the ability of Victoria and many other states to invest in current services and plan for future services.[13]

1.1.2 The Commonwealth also provides Victoria with specific-purpose grants

Table 1.4 lists the Commonwealth grants provided to Victoria for specific purposes by expenditure category. They include payments linked to National Agreements and National Partnerships.

The Commonwealth funds states to deliver key services through National Agreements and National Partnerships

The Commonwealth and state governments make intergovernmental agreements (IGAs) to outline their commitment to work together to achieve certain goals or objectives. When these agreements involve Commonwealth funding, they fall under the IGA on Federal Financial Relations (IGA FFR). Currently, the IGA FFR contains National Agreements in the areas of healthcare, education, skills and workforce development, and affordable housing.

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12 Victorian Department of Treasury and Finance, *Victorian Budget 2021–22 Paper No. 5*, p. 184.

13 Ibid., p. 185.

Table 1.4 Commonwealth grants to Victoria for specific purposes ($ million)

	2020–21 revised	2021–22 budget
Affordable housing		
National Housing and Homelessness Agreement	418	426
Total	**418**	**426**
Community services		
National Partnerships		
• *Assistance to states for DisabilityCare Australia* (NDIS transition)	253	261
• *Home and Community Care Assessment*	35	35
Other	14	2
Total	**302**	**298**
Education		
Quality schools funding (support for government schools)	2,102	2,280
National Agreement for Skills and Workforce Development	408	411
National Partnerships		
• *Universal access to early childhood education*	130	90
• *School Chaplaincy Program*	13	13
• *JobTrainer fund*	37	89
Other	1	..
Total	**2,691**	**2,883**
Environment		
National Partnerships		
• *Sustainable Rural Water Use and Infrastructure Program*	32	5
• *Hydrogen Energy Supply Chain Pilot Project*	13	..
• *Water Infrastructure Development Fund—capital component*	50	39
Other	16	1
Total	**110**	**45**
Health		
National Health Reform Agreement	7,182	6,400
National Partnerships		
• *Community Health and Hospitals Program*	19	41
• *Adult public dental services*	27	..
• *Victorian Cytology Service*	11	..
Other	12	9
Total	**7,251**	**6,450**
Infrastructure		
National Partnerships		
• *Infrastructure Investment Program*	701	641
• *Geelong City Deal*	5	135
Other	..	..
Total	**706**	**777**

	2020–21 revised	2021–22 budget
Contingent/other		
National Partnerships		
• *Legal Assistance Services*	83	77
Other	2,604	2,816
Total	**2,687**	**2,893**
Total grants for specific purposes	**14,164**	**13,772**

Note: .. = zero, or rounded to zero.

Source: Victorian Department of Treasury and Finance, *Victorian Budget 2021–22 Paper No. 5*, pp. 186–191.

National Agreements are ongoing agreements. Specific-purpose payments are linked to the National Agreements and are provided by the Commonwealth to the states to assist them to achieve the outputs and outcomes outlined in the National Agreements.

In addition, the Commonwealth makes payments to states under National Partnership agreements to assist them to achieve relevant outputs and outcomes. National Partnership agreements are fixed-term agreements that focus on projects of national importance, the delivery of reforms or service delivery improvements.

Victoria passes some Commonwealth grants on to other entities

The Victorian Government also receives Commonwealth grants that it passes on to other entities, including support for non-government schools and Financial Assistance Grants to local government. In addition, the Commonwealth provides payments to state agencies to deliver services on behalf of the Commonwealth, for example, payments to hospitals for Pharmaceutical Benefit Scheme and residential aged care subsidies. These payments are referred to as Commonwealth Own Purpose Expenditure or COPE.

1.2 Scope of inquiry

The terms of reference for this Inquiry required the Committee to consider the adequacy of Commonwealth support for Victoria. The Committee was specifically asked to examine Victoria's share of GST revenue and the implications of the end of the no-worse-off guarantee stipulated in the new equalisation arrangements. The terms of reference also allowed the Committee to explore other issues relating to Commonwealth support for Victoria and based on the evidence it received in submissions and at hearings, it chose to consider the level of Commonwealth investment in Victorian infrastructure, Commonwealth support for local government and Commonwealth assistance with COVID-19 recovery efforts.

1.3 Inquiry process

The Committee called for submissions to this Inquiry in September 2021 by advertising in *The Age* and on Facebook, LinkedIn and Twitter, and writing directly to about 110 stakeholders. The invited stakeholders included university economics departments, business groups, unions, research centres, social service organisations and Victorian and Australian government bodies.

The Committee received 10 submissions and held two days of public hearings over Zoom in December 2021. Appendix A lists the submissions received and the witnesses who gave evidence at the public hearings.

1.4 Report outline

This report consists of four chapters:

- This chapter, Chapter 1, introduces the Inquiry by outlining the Inquiry's context, scope and process.
- Chapter 2 explores Victoria's concerns about the new equalisation arrangements and the likely impact when the no-worse-off guarantee ends.
- Chapter 3 considers the level of Commonwealth support for Victorian infrastructure, local government and the recovery from the impacts of the COVID-19 pandemic.
- Chapter 4 provides a short conclusion to the report.

2 How the GST distribution reforms harm Victoria

The evidence received by the Committee overwhelmingly shows that Victoria will be worse off due to the GST distribution reforms. Under the new equalisation arrangements described in Chapter 1, Victoria will lose significant amounts of revenue when the no-worse-off guarantee expires. Stakeholders also noted the reforms undermine the intent of horizontal fiscal equalisation and will create inequity between Australia's states and territories (hereafter states). In addition, the no-worse-off guarantee payments will cost the Australian Government substantially more than it estimated when it proposed the changes. These arguments are outlined in the sections below and the chapter concludes with recommendations to prevent or minimise the negative impact of the reforms.

2.1 The reforms will erode the revenue of most states when the no-worse-off guarantee ends

The Commonwealth distributes GST revenue to the states based on the policy of horizontal fiscal equalisation (HFE). The Commonwealth Grants Commission (CGC) is the statutory body that advises the Australian Government on how to distribute GST revenue based on HFE by calculating state fiscal capacities and GST relativities. As discussed in Chapter 1, HFE is designed to equalise states' revenue-raising capacities and expense burdens so they can provide similar levels of services and infrastructure. In 2018, the Commonwealth introduced legislation that amended the equalisation arrangements (see Chapter 1 for specific details). These arrangements came into effect in 2021–22.

Under the former equalisation arrangements, states received a level of GST revenue that would allow them to provide government services and infrastructure at the same standard as the fiscally strongest state, which for the past 15 years has typically been Western Australia due to its high mining royalty revenue.[1] Under the new equalisation arrangements, states' fiscal capacities will be equalised so they can provide the same level of services as the stronger of Victoria and New South Wales (NSW). According to the Victorian Budget, this will result in a reduction in Victoria's GST relativity, the per capita weight that determines states' GST share, over the forward estimates. Victoria's GST relativity fell from 0.96 in 2020–21 to 0.92 in 2021–22.[2]

1 Mr Saul Eslake, Economist and Principal, Corinna Economic Advisory, *Submission 1*, p. 6.

2 Victorian Department of Treasury and Finance, *Victorian Budget 2021–22 Paper No. 5: statement of finances*, Melbourne, 2021, p. 182.

Furthermore, from 2022–23, the Commonwealth will implement a relativity floor of 0.70, which rises to 0.75 in 2024–25, meaning no state can have a GST relativity below the floor. This is expected to only affect Western Australia (WA), which had a GST relativity of 0.42 in 2021–22. When WA's GST relativity is lifted to the floor, every other states' relativity, and consequently their share of GST revenue, will fall to compensate.[3] As economist and Principal of Corinna Economic Advisory, Mr Saul Eslake, explains:

> because the distribution of any fixed sum—such as the revenue from the GST in any given year—is inherently a 'zero sum' game, any change which results in WA being better off *necessarily* makes the other states and territories (as a group) worse off.[4]

When the Commonwealth proposed the new equalisation arrangements in 2018, it argued that all states would be better off under the new system. It did so by basing its assumptions on a single scenario. However, most states noted that under different scenarios, all states other than WA would be worse off. They argued that the assumptions the Commonwealth used 'were flawed and failed to take into account a number of more realistic alternate scenarios.'[5]

In response, the Commonwealth legislated a no-worse-off guarantee until the system fully transitions to the new equalisation arrangements in 2026–27. Under the no-worse-off guarantee, states will receive a share of GST revenue based on the better of the old or new system.[6] To fund the no-worse-off guarantee payments, the Commonwealth introduced a permanent $600 million annual boost to the GST pool, which will be indexed and will increase to $850 million in 2024–25, when the relativity floor increases to 0.75.

Without the no-worse-off guarantee, states are fully exposed to the new arrangements and 'face the risk of an entrenched and ongoing loss of GST revenue.'[7] The Victorian Department of Treasury and Finance (DTF) added:

> Not only will most jurisdictions, other than WA, receive less GST once the guarantee expires, compared with the former system, but they will be cross-subsiding WA—the fiscally strongest state—from within the GST pool, further decreasing their respective GST shares.[8]

WA's Department of Treasury argued that due to the no-worse-off guarantee:

> every State, not just Western Australia, is benefitting from recent high iron ore prices. In this regard, other States continue to receive 90% of Western Australia's increased royalties through higher GST grants and the NWOG [no-worse-off guarantee] payments

3 Ibid.; ACT Government, *Submission 8*, p. 5.

4 Mr Saul Eslake, *Submission 1*, p. 7.

5 Tasmanian Department of Treasury and Finance, *Occasional Paper: new GST distribution arrangements*, Tasmanian Government, Hobart, 2021, p. 3.

6 Mr David Martine, Secretary, Department of Treasury and Finance, Victoria, public hearing, Melbourne, 15 December 2021, *Transcript of evidence*, p. 18.

7 Victorian Department of Treasury and Finance, *Submission 4*, p. 13.

8 Ibid.

> from the Commonwealth. Compared to the 2018 projections that were used to quantify the impact of the GST reforms, the other States can now expect to receive about $12 billion extra GST over 2020–21 to 2024–25 due to high iron ore prices. Victoria's share of these additional and unexpected iron ore royalties is around $3.5 billion.[9]

While Victoria and the other states are benefiting from higher iron ore prices, since they increase WA's revenue‑raising capacity and reduce its GST requirement, this will not apply to the same extent when the no‑worse‑off guarantee ends.[10]

The Victorian DTF estimates that without the no‑worse‑off guarantee, Victoria would be $3.3 billion worse off over the budget and forward estimates period.[11] Mr David Martine, Secretary of the Victorian DTF, presented the Committee with modelling showing how Victoria's GST share would fall under a range of different scenarios in 2027–28. He said:

> it is hard to forecast out that far, which is why we have run a whole range of different scenarios … if I pick a very plausible scenario … where relativities return to just their 10‑year average—which is not an unusual thing to do as a modeller … under that scenario in the year 2027–28, which would be the first year after the guarantee comes to an end, we would be $1 billion in GST revenue worse off than if the Commonwealth had not made these changes. New South Wales, for example, under that scenario would be $1.2 billion worse off. Western Australia under that scenario would be $4.3 billion better off. So we are talking very big numbers.
>
> So the stronger the resources sector is, the more revenue Western Australia receives—own‑source revenue—and under the old arrangement the less GST they would receive and the more GST we would receive. Under this arrangement Western Australia get to keep both their own‑source revenue and much higher GST payments at our expense after the guarantee comes to an end. So a loss of $1 billion in 2027–28—you know, $1 billion a year is a lot of government services that cannot be provided. We are talking pretty significant numbers here.[12]

In its submission, the Australian Capital Territory (ACT) Government presented the following table (Table 2.1) to compare the GST relativities that would apply in 2021–22 under the new system, the prior system and the blended system (which is how GST relativities are determined during the current transition period). In 2021–22, the blended relativity is equal to one‑sixth of the new system and five‑sixths of the old system. The following year, it will equal two‑sixths of the new system and four‑sixths of the old system, and so on until full transition to the new system in 2026–27.

Table 2.1 shows the GST relativities (using the blended calculation) fell in 2021–22 for every state other than WA compared with the prior system. If the new arrangements were fully operational in 2021–22, the relativities would also have fallen for every state other than WA. In this instance, WA's relativity would have jumped to 0.86 from 0.33 under the prior arrangements.

9 Western Australian Department of Treasury, *Submission 7*, p. 8.

10 Victorian Department of Treasury and Finance, *Victorian Budget 2021–22 Paper No. 5*, p. 183.

11 Victorian Department of Treasury and Finance, *Submission 4*, p. 18.

12 Mr David Martine, *Transcript of evidence*, p. 21.

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Table 2.1 GST relativities calculated using blended, prior and new equalisation arrangements, 2021–22

GST relativity	Vic	NSW	Qld	WA	SA	Tas	ACT	NT
Blended	0.92335	0.95617	1.05918	0.41967	1.34719	1.96067	1.16266	4.79985
Prior	0.93169	0.96451	1.06753	0.32852	1.35554	1.96901	1.17101	4.80820
New	0.86976	0.90258	1.00559	0.86359	1.29360	1.90707	1.10907	4.74626

Source: Adapted from ACT Government, *Submission 8*, p. 6.

To compare dollar amounts, the ACT Treasury and Economic Development Directorate calculated the GST grant levels each state would have received in 2021–22 if the new arrangements were fully implemented and the $850 million boost to the GST pool applied (see Table 2.2). This indicative modelling shows that all states except WA would have lost GST revenue, ranging from the Northern Territory (NT) losing $4 million to NSW losing $1.17 billion. Victoria would have lost $973 million. In per capita terms, Victoria would have lost the most at $145 less GST revenue per person. All states but the NT would have lost more than $110 per capita, while more than $4 billion of GST revenue (or $1,525 per capita) would be redistributed to WA.[13]

Table 2.2 Indicative GST grants under prior and new arrangements including $850 million boost, 2021–22

GST grant	Vic	NSW	Qld	WA	SA	Tas	ACT	NT
New ($ million)	16,531	20,803	14,881	6,543	6,478	2,933	1,352	3,257
New per capita ($)	2,462	2,555	2,847	2,445	3,662	5,399	3,140	13,436
Prior ($ million)	17,504	21,974	15,616	2,460	6,710	2,994	1,411	3,261
Prior per capita ($)	2,607	2,699	2,987	919	3,793	5,510	3,277	13,454
Difference ($ million)	**-973**	**-1,171**	**-734**	4,083	**-232**	**-60**	**-59**	**-4**
Difference per capita ($)	**-145**	**-144**	**-140**	1,525	**-131**	**-111**	**-137**	**-18**

Source: Adapted from ACT Government, *Submission 8*, p. 6.

The figures in Table 2.2 are based on the states' fiscal capacities in 2021–22, so they may not represent what will happen in 2027–28, when the no-worse-off guarantee no longer applies. However, if WA's mining production or iron ore prices increase by then, the negative effect on other states' GST share will be amplified. This could be significant if as in 2020–21, iron ore prices doubled from about US$100/tonne to over US$200/tonne.[14]

The ACT Directorate undertook sensitivity analysis of the impact of WA's mining production level by calculating the difference between the new and prior arrangements under a 10% increase or decrease in mining production in 2021–22. Table 2.3 presents

13 ACT Government, *Submission 8*, p. 6.

14 Ibid., pp. 6–7.

this analysis, which shows all states other than WA would have lost GST revenue under each scenario, except for the NT which would be marginally better off if WA's mining production decreased by 10%. WA would be better off under each scenario, gaining $3.5 billion if mining production fell and $4.3 billion if it increased.[15]

Table 2.3 **Indicative difference in GST grants under new and prior arrangements, sensitivity analysis based on WA mining production, 2021–22**

GST grant	Vic	NSW	Qld	WA	SA	Tas	ACT	NT
Difference—base case ($ million)	-973	-1,171	-734	4,083	-232	-60	-59	-4
Difference per capita—base case ($)	-145	-144	-140	1,525	-131	-111	-137	-18
Difference—10% increase ($ million)	-1,040	-1,252	-786	4,314	-249	-66	-63	-7
Difference per capita—10% increase ($)	-155	-154	-150	1,612	-141	-121	-147	-28
Difference—10% decrease ($ million)	-797	-958	-597	3,480	-185	-46	-48	2
Difference per capita—10% decrease ($)	-119	-118	-114	1,300	-105	-85	-111	8

Source: Adapted from ACT Government, *Submission 8*, p. 7.

Tables 2.2 and 2.3 highlight the significant impact on GST revenue for all states other than WA if the no-worse-off guarantee is not in place. When the guarantee ends in 2026–27, these states will no longer be insulated from the effects of the new equalisation arrangements.

As explained by Mr Mike Callaghan, Chairperson of the CGC, after the expiration of the no-worse-off guarantee:

> A state will be worse off if the reduction in its GST share as a result of increasing the GST relativity of another state is more than its share of the top-up payments in the GST pool.[16]

So if the required boost to WA is less than the top-up to the GST pool (which is $600 million in 2021–22), some states may be worse off and others may be better off. However, if WA requires a boost higher than the top-up amount, which seems probable based on states' modelling, then all states other than WA will be worse off.[17]

For example, the Victorian DTF modelled six different scenarios to show the impact of the new arrangements on GST revenue in 2027–28, after the no-worse-off guarantee expires. Under each scenario, Victoria's GST revenue falls, losing between $87 million

15 Ibid., p. 7.

16 Mr Mike Callaghan, Chairperson, Commonwealth Grants Commission, public hearing, Melbourne, 10 December 2021, *Transcript of evidence*, p. 2.

17 Ibid.

and $1.2 billion compared with the previous arrangements (see Section 2.3 for further explanation of the scenarios).[18] Modelling by the Tasmanian Department of Treasury and Finance estimates that it will lose $83 million in 2027–28.[19] Tasmania also predicts it will be $100 million per annum worse off on an ongoing basis from 2031–32, which 'may significantly impact Tasmania's ability to provide essential services, such as health, education and emergency services.'[20] Similarly, according to the Victorian DTF:

> The modelling demonstrates that not continuing the no-worse-off guarantee after 2026–27 will put many states—including Victoria—at risk of significant financial losses. This impedes not only states' ability to invest in vital services for their citizens now, such as education, health, and mental health—but also their ability to plan effectively into the future.[21]

Dr Angela Jackson, Lead Economist at Equity Economics, reiterated the impact of significant revenue loss on the states:

> the expiry of the no-worse-off clause, this is clearly going to have a huge impact I think, particularly across New South Wales and Victoria. It is going to benefit Western Australia, and there is no doubt about that. In terms of overall sums involved, in some ways at the Commonwealth level, as they spend $80 billion on a JobKeeper program, they probably think, 'Well, this isn't huge bucks; why are you caring?', but obviously we know for state governments it does matter—that a billion dollars is a lot of money, and not having access to that does mean real things in terms of what they can provide to their schools and to the hospitals and the services that Victorians need.[22]

According to the Victorian DTF, the potential loss of $1.2 billion in one year is equivalent to 'funding for up to 9,000 teachers, 9,200 police officers or over 10,000 nurses.'[23]

FINDING 1: All Australian states and territories other than Western Australia are predicted to lose GST revenue when the Commonwealth's new equalisation arrangements under the *Treasury Laws Amendment (Making Sure Every State and Territory Gets Their Fair Share of GST) Act 2018* (Cth) come into full effect in 2027–28.

FINDING 2: Modelling indicates that under the Commonwealth's new equalisation arrangements, Victoria could lose between $87 million and $1.2 billion of GST revenue in 2027–28 after the no-worse-off guarantee expires.

18 Victorian Department of Treasury and Finance, *Submission 4*, p. 1.

19 Mr Saul Eslake, *Submission 1*, p. 13.

20 Tasmanian Department of Treasury and Finance, *Occasional Paper: new GST distribution arrangements*, p. 10.

21 Victorian Department of Treasury and Finance, *Submission 4*, p. 21.

22 Dr Angela Jackson, Lead Economist, Equity Economics, public hearing, Melbourne, 10 December 2021, *Transcript of evidence*, p. 14.

23 Victorian Department of Treasury and Finance, *Submission 4*, p. 20.

2.1.1 All Victorians will be affected by the loss in GST revenue

GST is an important revenue source for Victoria and it has a strong impact on the level of services the Victorian Government can provide.[24] While Victoria's GST revenue has increased in dollar terms most years since the introduction of the GST in 2000–01, this is largely because of growth in the national GST pool and Victoria's population. Since 2018–19, the CGC's assessment of Victoria's fiscal capacity has improved, which has resulted in its GST relativity falling from 0.98670 in 2018–19 to 0.92335 in 2021–22. As a result, its GST share has also dropped.[25]

Notwithstanding the new equalisation arrangements, Victoria faces downward pressure on its GST relativity and revenue going forward due to increases in its own-source revenue and slower population growth, particularly after the restrictions to travel and migration during the COVID-19 pandemic.[26] According to Mr Eslake, when the no-worse-off guarantee expires:

> Inevitably that will mean, unless something changes between now and then, that Victorians will experience a reduction in the amount of spending on public services or have to pay higher state taxes and charges or some combination of those two and possibly incur bigger state budget deficits.[27]

Economist and Visiting Fellow at the Australian National University, Mr Chris Murphy, agreed, stating:

> it would put Victoria in a worse fiscal position than would be efficient … Victoria would not be able to offer the same kinds of services. It would have to raise more taxes than would optimally be the case … in the longer run the effects are more to do with people moving. So if services are not as good or taxes are higher, some people are likely to move to other states where they can get a better fiscal deal. So while in the short term … there are inequity issues—in the longer term there are also economic efficiency issues in that people will no longer be in the states in which they can make the most economic contribution, because their state government's budget has been artificially penalised, so the state is not [in] a position to offer the services that it should be able to offer.[28]

Dr Jackson added that the lower level of revenue will make it harder for the Government to respond to increased demand for services in the future and this may lead to higher state debt levels:

> ultimately it will mean less money for those services for the Victorian people and it will mean less ability to increase services as well for the Victorian people and to meet the future demand. Because I think one of the things obviously also to keep in mind is, yes, some services are relatively flat—as you would know, in the budget—and some

24 Mr David Martine, *Transcript of evidence*, p. 18.

25 Victorian Department of Treasury and Finance, *Submission 4*, pp. 5–6.

26 Ibid., p. 6.

27 Mr Saul Eslake, Economist and Principal, Corinna Economic Advisory, public hearing, Melbourne, 10 December 2021, *Transcript of evidence*, p. 9.

28 Mr Chris Murphy, Economist and Visiting Fellow, Australian National University, public hearing, Melbourne, 10 December 2021, *Transcript of evidence*, p. 22.

> things are relatively stable, but other services are obviously growing very quickly, health being one. So the ability to respond to that and to meet the demands and the needs is going to be diminished clearly, and that is going to mean longer wait times. It is going to mean more stretched services for the Victorian people. Alternately, and this is in terms of the budget, I guess the other choice is to just spend the money and to go more into debt. Well, the debt level is already projected to be relatively high, and that will create greater uncertainty and greater risk around that fiscal position going forward, particularly in an environment where internationally we may see interest rates rising and that will put even more pressure on the budget.[29]

Stakeholders informed the Committee of how lower GST revenue is likely to affect different groups of Victorians. For example, Dr Jackson explained that if the Victorian Government had to spend less on early childhood and education than it currently does, it would reduce female participation in the workforce as women reduce their hours of work. In addition, the Victorian Government would be limited in its ability to invest in domestic violence and mental health measures, which will have a 'disproportionate impact on women'.[30]

Ms Emma King, Chief Executive Officer of the Victorian Council of Social Service, the peak body for social and community services in Victoria, added that services for Victorians facing disadvantage will also suffer:

> I note that based on the current forecasts DTF estimates that Victoria will be $4.5 billion worse off under the new system over the budget and forward estimates period without the no-worse-off guarantee. So I think it is pretty hard to categorise that in any other way than catastrophic, really—the notion that we could get by with such a significant reduction in income and think that that will not have an impact across the whole of our society wherever you look. At the end of the day when there are cuts or when there are disasters like we have just seen, we know that people who are on low incomes and who are poor and who are disadvantaged are impacted the first, the hardest and the longest. And if that much money is going to come out of our system, it is hard to see how we will not have more Victorians that are actually going to be reliant on welfare and on social assistance and who are living in poverty. And it is hard to see how frontline organisations are actually going to receive the funding and the support et cetera that they need to be able to deliver for the most vulnerable in our communities. The only way I can describe it is it would be genuinely catastrophic.[31]

Regional Victorians will also be affected by a reduction in GST revenue, according to Ms Win Scott, Chair of the Mallee Regional Partnership, which is one of nine partnerships in Victoria that act as a voice for their regions and advise the Victorian Government on regional priorities.[32] Less funding for the regions would result in pressure to rationalise or withdraw services. If services are withdrawn, particularly in

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29 Dr Angela Jackson, *Transcript of evidence*, p. 16.

30 Ibid., p. 18.

31 Ms Emma King, Chief Executive Officer, Victorian Council of Social Service, public hearing, Melbourne, 15 December 2021, *Transcript of evidence*, p. 32.

32 Ms Winifred Scott, Chair, Mallee Regional Partnership, Regional Partnerships, public hearing, Melbourne, 15 December 2021, *Transcript of evidence*, p. 34.

smaller regional centres, there would be a negative impact on employment, population growth and town viability, which would result in fewer visitors, investors and new residents in these areas.

Similarly, businesses across Victoria will also feel the impact of lower GST revenue. As explained by Mr Dylan Broomfield, General Manager of Policy and Advocacy at the Victorian Chamber of Commerce and Industry, which represents and supports Victorian businesses, the loss of GST revenue:

> has significant implications which in turn impact business, either through the State Government having to increase taxes, such as we saw with the mental health levy, or the level of spending on infrastructure not being as high as it could be, which in turn presents significant challenges for businesses not being able to get as great access as they otherwise would be able to.
>
> We know from our own work that Victoria is the highest cost state for business, and a fairer allocation of GST could provide the means through which reductions in some of these costs could be achieved.[33]

Ultimately, Victoria's loss of GST revenue when the no-worse-off guarantee expires will require the incumbent government to cut vital services, including health and education, or look for other forms of revenue, such as state taxes.[34]

FINDING 3: The significant loss of GST revenue following the expiration of the no-worse-off guarantee will oblige future Victorian governments to cut vital public services such as health and education, impose higher or new state taxes to raise revenue and/or incur more debt.

2.2 The reforms undermine the intent of horizontal fiscal equalisation

The rationale of HFE is to ensure fiscal equity across Australia, so that each state has the capacity to provide its residents the same standard of government services and infrastructure. However, the Victorian DTF believes the new equalisation arrangements compromise this objective:

> Victoria recognises its role as a fiscally stronger State, subsidising fiscally weaker states to achieve HFE through the GST system.
>
> However, the Commonwealth Government's legislated changes in 2018 have now compromised the underlying intent of the GST system and have seriously undermined its operation. The new system no longer achieves HFE and does not address the key concerns raised when motivating its introduction.[35]

33 Mr Dylan Broomfield, General Manager, Policy and Advocacy, Victorian Chamber of Commerce and Industry, public hearing, Melbourne, 15 December 2021, *Transcript of evidence*, p. 24.

34 Ibid., p. 26.

35 Victorian Department of Treasury and Finance, *Submission 4*, p. 22.

DTF states that Victoria supports the principle of HFE, but methods of GST revenue distribution should ensure it is not disadvantaged by being one of the fiscally stronger states, noting Victoria has the second lowest GST revenue per capita of all the states.[36]

The following sections discuss the rationale for HFE, states' past and current concerns with HFE, and past inquiries into HFE before outlining the rationale proposed for the new equalisation arrangements.

2.2.1 Horizontal fiscal equalisation has generally served Australia well

While the purpose of HFE is equity, states across Australia have differing views on how well the policy operates in practice. Fiscally stronger states are sometimes aggrieved they receive less than their population share of GST revenue, whereas fiscally weaker states argue HFE offsets geographic and demographic differences that make revenue raising harder and/or service provision more expensive for them. The reasons for these views are outlined below.

Australian states are highly dependent on Commonwealth grants

Australia's fiscal system has a high degree of vertical fiscal imbalance. This means the Commonwealth has much greater revenue-raising powers than the states, but it is the states, and to a lesser extent councils, that are responsible for the delivery of most services. To illustrate, in 2018–19, 81.4% of tax revenue was raised by the Commonwealth compared with 15.2% by state governments and 3.4% by local governments.[37] Australia's level of vertical fiscal imbalance has been described as 'the most extreme of any federation in the industrial world.'[38]

Consequently, states finance their services using a combination of own-source revenue and Commonwealth funding in the form of tied and untied (GST revenue) grants. As the CGC explains, 'Because of vertical fiscal imbalance, no State has the capacity to provide the average level of services without this combination of funding support from the Commonwealth.'[39]

Since the states are highly dependent on Commonwealth grants, the Australian Government has a large influence on how tax revenue is distributed between them.[40] This can create friction according to Dr Jackson as states struggle:

> to really meet the needs of their population in the best way they see fit …

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36 Ibid., p. 9.

37 Municipal Association of Victoria, *Submission 6*, p. 6.

38 Anne Twomey and Glenn Withers, *Australia's federal future: delivering growth and prosperity*, report for the Council for the Australian Federation, April 2007, p. 37.

39 Commonwealth Grants Commission, *Submission on the draft report from the Commonwealth Grants Commission*, submission to Productivity Commission, Inquiry into horizontal fiscal equalisation, 2017, p. 3.

40 Mr Saul Eslake, *Submission 1*, p. 2.

> you are relying on the Commonwealth all the time to give the money to the states and the local governments to deliver the services they want to deliver. That creates fights, friction. It politicises the process and means really for state governments they cannot plan properly.[41]

Therefore, states can be aggrieved if they do not agree with how the CGC applies its equalisation measures.

Efficient equalisation creates equity and supports optimal labour allocation

When applying the principle of HFE, the CGC considers states' revenue-raising capabilities and their costs to provide the same standard of government services and infrastructure. According to Mr Callaghan from the CGC, the following factors are significant:

- states' mining resources, due to the ability to raise revenue from royalties, their uneven distribution across the country and the volatility of their value
- property prices, due to the ability to raise revenue from stamp duty on conveyances and land tax, as well as the influence of property cycles in each state
- the remoteness of people's place of residence, due to the higher cost of providing services in regional and remote areas
- the Indigenous and socioeconomic status of residents, due to typically higher needs for services among Aboriginal people and people from lower socioeconomic backgrounds
- wage levels, due to their impact on the cost of services and their revenue-raising capacity through payroll tax
- population growth, due to a greater demand for infrastructure among growing populations
- natural disasters, due to the greater need for service provision.[42]

These factors regularly result in the CGC assessing Victoria, New South Wales and Western Australia as fiscally stronger than other states and therefore requiring a GST share that is lower than their population share. For example, less than 4% of Victoria's population in 2019 lived in an outer regional, remote or very remote location compared with 10% of the national population. Similarly, Aboriginal people make up less than 1% of Victoria's population compared with 3% nationally.[43]

After calculating the states' fiscal capacities, the CGC equalises GST distribution based on directions from the Australian Treasurer. Under the former equalisation process, this involved four stages as shown in Figure 2.1. The first stage determined each states' fiscal

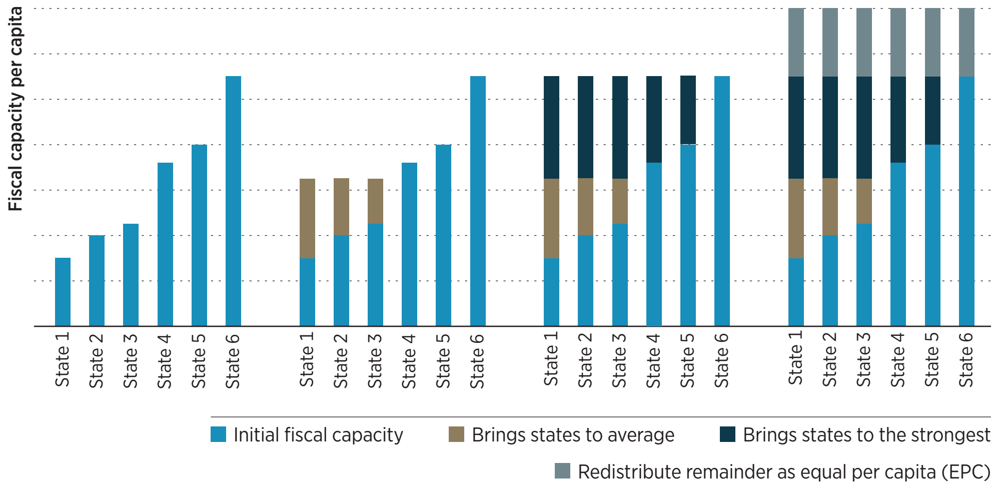
41 Dr Angela Jackson, *Transcript of evidence*, p. 14.

42 Mr Mike Callaghan, *Transcript of evidence*, p. 5.

43 Western Australian Department of Treasury, *Submission 7*, p. 3.

capacity per capita. The second stage distributed revenue to lift the fiscally weaker states to the national average fiscal capacity and the third stage distributed revenue to lift all states to the fiscal capacity of the strongest state. The final stage redistributed the remaining GST revenue on a per capita basis.

Figure 2.1 Stages of the former equalisation process



Source: Adapted from Victorian Department of Treasury and Finance, *Submission 4*, p. 11.

According to Mr Jonathan Coppel, a full-time Commissioner between 2011 and 2021 at the Productivity Commission (PC), which provides independent research and advice to the Australian Government on economic, social and environmental issues, the size of this equalisation task had been growing since the introduction of the GST, peaking in 2016–17 at 12–13%. This was due to increasing disparities between the states in relation to mining, regional and remoteness costs, and Indigenous status. He also noted that despite this process, the CGC is not able to achieve perfect equalisation due to data limitations and conceptual considerations. Even so, Australia's former equalisation arrangements achieved full equalisation and almost eliminated fiscal disparities between the states unlike similar processes in Canada and Germany, which leave disparities between provinces and states, respectively.[44]

In addition to creating fiscal equity between states, HFE also improves economic efficiency by ensuring people reside in the states where there are more employment opportunities and businesses are located where their productivity is maximised. Without HFE, states that can offer lower taxes or a better level of services would attract more people and businesses, potentially creating economic inefficiencies and labour shortages in the other states. HFE also has the potential to insulate individual states against adverse economic shocks, even though this is not a main objective of HFE.[45]

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44 Jonathan Coppel, 'The economic impacts of HFE: lessons from Australia', paper presented at 14th annual meeting of the OECD Network on Fiscal Relations Across Levels of Government, Paris, 19–20 November 2018, p. 11; Mr Saul Eslake, *Submission 1*, p. 4.

45 Government of South Australia, *Submission 10*, p. 4; Jonathan Coppel, 'The economic impacts of HFE', pp. 5, 23.

Fiscally stronger states have raised concerns with how HFE operates

Despite Australia achieving full equalisation under the former equalisation arrangements, some states, chiefly the fiscally stronger states, were dissatisfied with the operation of HFE. Their main concerns were:

- their GST share was lower than their share of the population, in particular Western Australia, whose GST relativity fell to 0.34 in 2017–18
- the lag in GST assessments due to data availability and use of a three-year moving average for GST relativity means GST share does not reflect states' current economic circumstances, which has become an issue during the global financial crisis, the mining boom and the COVID-19 pandemic
- HFE acts as a disincentive for fiscally weaker state governments to reform their tax system or pursue other economic reforms because they would risk losing GST revenue.[46]

In its submission, the WA Department of Treasury outlined additional concerns, namely:

- the volatility of iron ore royalty revenue creates volatility in the value of WA's GST grants and this uncertainty makes it difficult to manage the state budget
- the way the CGC assesses state policy and efficiency has shortfalls because defining average policy is difficult
- the former equalisation arrangements did not acknowledge greater infrastructure requirements for growing populations until 2010, and Western Australia has not been compensated for the prior under-assessment
- the former equalisation arrangements did not compensate for infrastructure and related support for mining developments, therefore ignoring the substantial investment of the WA Government and the risks it took on to provide this infrastructure, which benefits all of Australia
- the CGC does not adequately recognise the unique high costs WA faces to provide services, including costs relating to remoteness.[47]

The WA Department of Treasury argued the new equalisation arrangements recognise the uncertainty and shortfalls in the CGC's methods and through the relativity floor set 'a limit on how much funding is redistributed away from any one State.'[48]

These views were not shared by other stakeholders participating in this Inquiry. For example, Mr Eslake noted the argument that HFE discourages state governments from pursuing economic reforms including tax reform has been rejected by several reviews

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46 Productivity Commission, *Horizontal fiscal equalisation: Productivity Commission inquiry report overview & recommendations*, Commonwealth of Australia, Canberra, 2018, p. 3; Victorian Department of Treasury and Finance, *Submission 4*, p. 4; Mr Saul Eslake, *Transcript of evidence*, p. 12.

47 Western Australian Department of Treasury, *Submission 7*, pp. 5–6.

48 Ibid., p. 10.

dating back to 1993, which were unable to find evidence to prove this theory.[49] Further information on previous inquiries into HFE is presented in the next section.

Also, Mr Callaghan from the CGC explained the three-year moving average approach to calculating GST relativities is necessary to ensure the most reliable data are used and to minimise the impact of economic shocks to state revenues. He said that most states support this method because it smooths volatility and helps their budgetary planning.[50] He added:

> We do have to wait to get the most recent data, and also data that will not be subject—hopefully not subject—to too many revisions, and we also average it over three years. Now, that does mean, in the case of Western Australia, if iron ore prices are coming down there is a lag in terms of when that decline would be impacting on their assessment and their fiscal capacity for GST. It also works the other way of course. If iron ore prices are rising, there is a lag before that increase in revenue capacity would result in them receiving less GST. The reason for doing that average is to try and provide a bit more stability against the volatility in the factors that are influencing the GST.[51]

Mr Callaghan also explained how the CGC's assessment process is done in close consultation with the states to obtain accurate data and the states' views on the CGC's methods. Once the CGC makes a decision after considering states' comments and the quality of available data, it reports its reasoning to the states. He said:

> we are always open. It is an ongoing dialogue. Quite often new evidence will come up in the sense of new data sources, things can change and different assessments can be done, which will result in different outcomes of GST distribution.[52]

The CGC aims to determine policy-neutral ways of assessing states' revenue and service costs, so that if a state decides to pay its public servants higher wages or lower its taxes, this does not result in a higher GST share.[53] In addition, the CGC reviews its methodology every five years in consultation with the states. The last review was conducted in 2020. Mr Callaghan stated:

> So the states have the opportunity to regularly—and ongoing—input their views. But as I say, because it is a fixed sum of money that is being distributed and changes in method will result in different distributions, states will always, you could say, be aggrieved at some stage or have different views. But it is an ongoing process of always considering it, and in some respects it is an evolutionary process.[54]

A current concern of the Victorian DTF is how the CGC will treat expenditure related to the COVID-19 pandemic considering Victoria and NSW have spent more than other states due to their extended lockdowns, business support and additional funding for the

49 Mr Saul Eslake, *Submission 1*, p. 4.

50 Mr Mike Callaghan, *Transcript of evidence*, p. 6.

51 Ibid.

52 Ibid., p. 4.

53 Mr Jonathan Rollings, Secretary, Commonwealth Grants Commission, public hearing, Melbourne, 10 December 2021, *Transcript of evidence*, p. 6.

54 Mr Mike Callaghan, *Transcript of evidence*, p. 4.

healthcare system.[55] Mr Callaghan noted the CGC's approach will depend on the terms of reference it receives from the Australian Treasurer, which will indicate how much flexibility the CGC can apply to its methods when considering the impact of COVID-19 on states' expenditure. The lag due to data availability and the three-year moving average approach also means that the full impact of COVID-19 will not be included in the GST relativity calculations for this year and next year.[56]

Despite some states' concerns, the former equalisation arrangements, worked effectively and produced expenditure choices that would resemble those of nations without vertical fiscal imbalance, according to Mr Eslake. He told the Committee:

> my view is that the system which we had that applied from 1981 until basically the past 12 months was as pretty close to an ideal as you could get, in that we did achieve a substantial degree of equalisation of fiscal capacity across states and territories that has reduced spatial inequality among Australian citizens to a much greater extent than has been achieved in the United States, Canada, Germany, Switzerland and other democratic federations. It is perhaps worth making the point in that context that if by some chance Australia had had a unitary system of government, like New Zealand's or the United Kingdom's, where decisions about what we in Australia regard as state-type public services—education, health, policing—were made instead by the national government, then almost certainly they would distribute spending on education, health, police, housing and so forth in a way similar to the outcomes that the Grants Commission's recommendations have produced. In other words, if the decision as to what was spent where on school education, for example, was made in Canberra, it is highly likely that Canberra would spend more on education in the poorest parts of Australia and less in the richest parts of Australia, whereas in effect we achieve similar outcomes through the distribution of GST revenues to states and territories on the basis of the recommendations by the Grants Commission.[57]

2.2.2 Inquiries into HFE prior to 2018 did not result in significant changes

In addition to the CGC's annual updates and five-yearly methodological reviews, several systematic reviews of HFE were undertaken between the introduction of the GST and 2018. None found evidence that HFE disincentivises states from implementing economic reform and none resulted in significant changes to how HFE is applied.[58] The main reviews were:

- 2002 review of Commonwealth–state funding commissioned by the governments of NSW, Victoria and WA and undertaken by economists Ross Garnaut and Vince Fitzgerald

55 Mr David Martine, *Transcript of evidence*, p. 20.

56 Mr Mike Callaghan, *Transcript of evidence*, p. 4.

57 Mr Saul Eslake, *Transcript of evidence*, p. 11.

58 Adrian Makeham-Kirchner, *Treasury Laws Amendment (Making Sure Every State and Territory Gets Their Fair Share of GST) Bill 2018*, Bills digest, no. 42, 2018–19, Parliament of Australia, Canberra, 2018, pp. 7–8; Mr Saul Eslake, *Submission 1*, p. 4.

- 2012 GST distribution review commissioned by Prime Minister Julia Gillard and undertaken by a panel consisting of former premiers John Brumby (Victoria) and Nick Greiner (NSW) and former member of the Executive Committee of Cabinet of the Government of South Australia (SA) Bruce Carter
- 2014 National Commission of Audit report, which considered changes to HFE and ways to address vertical fiscal imbalance as part of its investigation into the scope and efficiency of the Commonwealth Government
- 2015 Reform of the Federation White Paper, which was intended to clarify the roles and responsibilities of the states and the Commonwealth and identify ways to reduce duplication and achieve a more efficient and effective federation, but ultimately did not produce a final report.[59]

The 2002 and 2014 reviews recommended GST revenue be distributed on an equal per capita basis with additional grants to fiscally weaker states to ensure they are not worse off than the existing equalisation process. Victoria supported this approach in its submission to the 2012 review.[60] The 2012 review also considered this approach to HFE, along with other approaches such as a 0.75 relativity floor, but found none 'would be simpler, more transparent or improve efficiency' than the existing approach.[61]

The 2012 review found a 0.75 relativity floor would soon create wide fiscal disparities between the states and there was no compelling evidence to support it. In its submission to the review, the Australian Treasury also did not support a relativity floor as it would increase complexity and reduce predictability for fiscally weaker states.[62]

According to economist Mr Murphy in 2018, both approaches ultimately do not lead to a more favourable outcome than the existing system:

> The "75c floor" scenario', like the "grants" scenario, reflects an apparently superficial view of equalisation. Its focus on GST relativities ties equalisation transfers to GST revenue. In fact, equalisation transfers could be completely separated from GST revenue with no difference in final outcomes. Donor states would then contribute to a special pool and recipient states would draw from the same pool. GST distributions would be made separately on an EPC [equal per capita] basis. This separated system would lead to exactly the same outcome for each state as the existing system. Thus, focussing on GST grants pool relativities confuses the fiscal equalisation policy with its current delivery mechanism. This highlights the arbitrary nature of setting a floor on grants pool relativities.[63]

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59 Makeham-Kirchner, *Treasury Laws Amendment (Making Sure Every State and Territory Gets Their Fair Share of GST) Bill 2018*, pp. 7–8.

60 Victorian Government, *GST distribution review: Victorian submission*, submission to GST Distribution Review Panel, GST distrubution review, October 2011, p. iii.

61 Makeham-Kirchner, *Treasury Laws Amendment (Making Sure Every State and Territory Gets Their Fair Share of GST) Bill 2018*, pp. 7–8; The Australian Treasury, *GST distribution review: final report*, Commonwealth of Australia, Canberra, 2012, p. 5.

62 Makeham-Kirchner, *Treasury Laws Amendment (Making Sure Every State and Territory Gets Their Fair Share of GST) Bill 2018*, pp. 16–17.

63 Chris Murphy, *Optimal fiscal equalisation and its application to Australia*, Working Paper in Trade and Development, no. 2017/12, Australian National University, Canberra, September 2017, p. 30.

In its report for the 2012 review, the panel dispelled the 'myths' about HFE, stating:

> many of the concerns about HFE have turned out to be overstated, while others have reflected either the practical limitations of the system, or a matter of judgement about the result, rather than a proposition capable of technical proof. Still other concerns have, in the Panel's view, represented symptoms of the present economic times rather than problems with HFE per se. This does not mean they can be ignored, but it does mean that they need to be considered in the proper context, and the responses to them need to be appropriately restrained.
>
> Even where concerns have proven legitimate, we have carefully examined all potential solutions to these concerns to ensure that the 'cure' is not worse than the 'disease', and to consider whether any cost associated with a solution is proportionate to the benefit it is expected to bring.[64]

The panel did not find another approach to HFE that was preferable to the system existing at the time. Instead, it recommended ways to 'improve understanding of the HFE system in Australia, increase the transparency of the process and strengthen governance arrangements.'[65] While it found mining revenue should continue to be equalised, it acknowledged mining revenue may not be policy neutral and that the CGC may not 'properly recognise' some mining costs. It suggested a temporary 3% discount to mining revenue assessments until the CGC could develop a new mining revenue assessment that addressed these concerns. The Panel also concluded there was little practical evidence to prove theoretical perverse incentives for states to minimise productivity and that to reduce the possibility of them occurring would create fiscal disparities between the states.[66]

2.2.3 Productivity Commission found theoretical but unproven concerns with HFE justify changes to equalisation arrangements

It is against the backdrop of the WA mining boom—which led to WA's GST share falling to a record low—that the then Australian Treasurer Scott Morrison asked the PC to inquire into Australia's system of HFE. When WA's GST relativity fell to 0.3 in 2015–16 it coincided with its iron ore royalty revenue falling by 26% in 2014–15 and by a further 11% in 2015–16. This followed a 42% increase in 2013–14. (In contrast, WA's GST share increased by 41% in 2018–19 at the same time its iron ore royalty revenue increased by 32%.) These figures reflect the lack of contemporaneity of GST relativity calculations due to data availability and the use of the three-year moving average.[67]

Both Tasmania and SA argue that prior to 2007–08, 'Western Australia was a beneficiary of HFE—receiving more than its population share of the GST' but this was overturned when WA's mineral royalties rose rapidly during the 2009–2013 mining

64 The Australian Treasury, *GST distribution review*, p. v.

65 Ibid., p. vi.

66 Ibid., p. 7.

67 Government of South Australia, *Submission 10*, p. 3.

boom.[68] Successive WA governments of both major parties complained that WA's GST share was diminishing. In 2017, the Australian Treasurer gave the PC terms of reference, which Mr Eslake argues echoed WA's complaints and so 'were "loaded" in such a way as to encourage it [PC] to produce a result that would find favour in Western Australia'.[69]

In his summary of the PC's 2018 report, Mr Coppel states the PC was asked to examine the impacts of the current HFE system on the Australian community, economy and state governments, and then assess and propose preferable alternatives to the current system.[70] The PC's final report was finished in May 2018 and tabled in Parliament in July 2018. It found:

- the premise of HFE was broadly supported by all levels of government, but the approach to HFE was facing scrutiny due to WA's falling GST share
- the strengths of the existing HFE approach included its ability to achieve almost complete fiscal equalisation and the CGC's well-established and consultative process for recommending GST relativities
- the weaknesses of the existing HFE approach included its scope for discouraging states to reform taxation and adopt productive mineral and energy policies
- there was a need to balance equity and efficiency and the Commonwealth should revise the objective of HFE so it provides states with the fiscal capacity to provide a reasonable (rather than the same) standard of services.[71]

In response to concerns that the existing HFE approach discouraged states from pursuing tax reforms, the PC found:

> there is little doubt that State tax reform disincentives exist in principle. Whether such effects actually influence policy decisions is harder to discern; decisions not to pursue reforms are impossible to directly observe. Not surprisingly, there is widespread disagreement on the occurrence and magnitude of disincentive effects, and conclusive evidence is scarce.[72]

It also found no direct evidence to substantiate claims that the existing HFE approach was a disincentive for states to pursue productivity-enhancing reforms.[73]

According to the PC, the uneven distribution of mineral and energy resources across states increased the potential for HFE to distort state policy. For example, WA has 98% of the nation's iron ore production, so its iron ore policy is effectively the nation's average policy. Its treatment during equalisation is therefore not policy neutral because any changes to state policy would directly affect WA's GST share. The PC stated,

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68 Tasmanian Department of Treasury and Finance, *Occasional Paper: new GST distribution arrangements*, p. 5; Government of South Australia, *Submission 10*, p. 2.

69 Mr Saul Eslake, *Submission 1*, p. 5.

70 Jonathan Coppel, 'The economic impacts of HFE', p. 3.

71 Productivity Commission, *Horizontal fiscal equalisation*, p. 2.

72 Jonathan Coppel, 'The economic impacts of HFE', p. 15.

73 Ibid., p. 20.

'while there is limited direct evidence that GST effects have influenced specific policy decisions, the disincentive effects for some States are palpable.'[74]

Despite finding 'limited direct evidence' to prove these theoretical impacts, the PC stated, 'absence of evidence is not equivalent to evidence of absence.'[75] It subsequently argued that:

> A revision to the objective of HFE would be in the best interests of national productivity and wellbeing, and is an essential precursor to achieving other improvements to the HFE system. The primary objective of the HFE system should be to provide the States with the fiscal capacity to supply services and associated infrastructure of a reasonable (rather than the same) standard. A similar objective has been adopted in several other countries, including Canada, where equalisation is intended to achieve 'reasonably comparable' levels of public services at reasonably comparable levels of taxation across provinces.
>
> Like the current approach to HFE, this proposed objective puts fiscal equality at the heart of HFE. However, the revised objective acknowledges the trade-off between full and comprehensive equalisation on the one hand, and fairness and efficiency on the other.[76]

After assessing alternate approaches to HFE, the PC recommended equalising to the average of all states' fiscal capacities as the best and most stable approach for deriving GST relativities.[77]

Regarding the CGC's use of the three-year moving average to calculate GST relativities, the PC found, 'Trying to increase the contemporaneity of the assessment could introduce additional complexity and volatility.'[78] Mr Coppel added:

> Even with limited contemporaneity, States should be able to manage the budgetary implications of lagged GST payments. Given the retrospective nature of the CGC's assessment processes, States are generally able to forecast the direction of changes in their GST relativities.[79]

Victoria and Tasmania agreed with this assessment. For example, the Tasmanian Department of Treasury and Finance argued:

> While the reduction in relativity was expected—and was highlighted as early as the 2011–12 Western Australian Budget—the Western Australia Government continued to increase recurrent expenditure by historically high levels. Much of this expenditure became structurally embedded in the Budget and was difficult to unwind once GST revenue started to decline.[80]

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74 Ibid., pp. 18–19; Productivity Commission, *Horizontal fiscal equalisation*, p. 38.

75 Productivity Commission, *Horizontal fiscal equalisation*, p. 15.

76 Ibid., pp. 18–19.

77 Ibid., p. 32.

78 Ibid., p. 11.

79 Jonathan Coppel, 'The economic impacts of HFE', p. 22.

80 Tasmanian Department of Treasury and Finance, *Occasional Paper: new GST distribution arrangements*, p. 5.

Similarly, the Victorian Government stated in its submission to the PC inquiry:

> The effect of the mining boom on WA's GST distribution, as demonstrated in this submission, was predictable and it was incumbent on the WA Government to manage its finances accordingly. To adjust the system such that WA would receive a windfall gain permanently, at the expense of all other Australians, would fundamentally undermine the principle of equity on which HFE is based.[81]

This sentiment of undermining HFE was echoed by Tasmania:

> The Tasmanian Government was also of the view that the proposed changes to the benefit of one State at the expense of all other States were unwarranted and would undermine the equitable basis on which the HFE system was built and would lead to growing inequality between the States.[82]

The Government of SA also argued that a shift away from full equalisation undermines the productivity, efficiency and equity principles of HFE.[83] While SA acknowledged the volatility of WA's GST relativity due to the lack of contemporaneity, it stated:

> the impact of the lag in the system is only material in the case of iron ore revenue, due to its volatile pricing, its concentration in a single state with a relatively small population, and its dominance as a revenue source for that state. The lag does not cause material impact in relation to other revenue sources.
>
> A shift away from the principle of HFE is not an appropriate response to volatility in a single revenue source.[84]

Both Victoria and Tasmania felt the PC had not made a convincing case for change since 'there was little, if any, evidence to support the key rationale the PC used to motivate a change to the system' and 'its conclusions were predicated on assertions, not evidence'.[85]

Other states reacted to the PC inquiry in the following ways:

- NSW highlighted several concerns with the PC's report and reiterated its preference for an equal per capita approach to equalisation. The 2021–22 NSW Budget states, 'Commonwealth changes to how GST is distributed under horizontal fiscal equalisation (HFE) are inequitable and unsustainable.'
- Queensland also had concerns with the PC's proposals stating they would allow some states to provide a higher standard of services and they did not address disincentives for states to pursue efficiency-enhancing reforms. It called for a broader review of federal financial relations.

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81 Victorian Government, *Victorian Government submission*, submission to Productivity Commission, Inquiry into Australia's system of horizontal fiscal equalisation, 2017, p. i.

82 Tasmanian Department of Treasury and Finance, *Occasional Paper: new GST distribution arrangements*, p. 6.

83 Government of South Australia, *Submission 10*, p. 2.

84 Ibid., pp. 3–4.

85 Victorian Department of Treasury and Finance, *Submission 4*, p. 10; Tasmanian Department of Treasury and Finance, *Occasional Paper: new GST distribution arrangements*, p. 5.

- WA supported the PC's finding that there was a need to reform HFE but favoured an equal per capita approach with the Commonwealth supporting fiscally weaker states directly.
- The NT objected to the PC's draft recommendations and stated, 'if the PC's recommendations are adopted, they will only benefit one state, to the detriment of all other states for the foreseeable future.'[86]

The Australian Treasurer tabled the PC's report in Parliament in July 2018 and at the same time tabled the Australian Government's interim response. The interim response committed to implementing changes to the HFE approach, which was a break from the convention of not committing to any changes in response to other HFE reviews. The Council on Federal Financial Relations, which oversees the financial relationship between the Commonwealth and state governments and consists of their treasurers, discussed the changes on 3 October 2018 and the Bill to implement these changes was introduced on 18 October 2018.[87] The Treasury Laws Amendment (Making Sure Every State and Territory Gets Their Fair Share of GST) Bill 2018 (Cth) received assent on 29 November 2018.

2.2.4 The new equalisation arrangements create fiscal disparities

The changes outlined in the Australian Government's interim response had not been considered by the PC in its review. The PC had recommended equalising to the average state fiscal capacity and had not canvassed equalising to the stronger of NSW and Victoria, which is the basis of the new equalisation arrangements. While the PC considered equalising to the second strongest state, it did not recommend this approach because it found it did little to improve efficiency, only reduced policy disincentives for the fiscally strongest state and could potentially result in fiscal outliers distorting equalisation. The Government's interim response rejected this argument without presenting evidence to back its views.[88]

Another issue with basing equalisation on the stronger of NSW and Victoria is that it does not factor the possibility that another state (such as Queensland, which has been the second strongest state twice since the introduction of the GST) could become stronger over time. Under the new equalisation arrangements, any state that is stronger than NSW and Victoria would gain the same advantages as WA.[89]

The introduction of the relativity floor is also contentious since no review of HFE has found it an ideal approach. The PC, which considered a relativity floor, stated it would result in partial equalisation, increase complexity and unpredictability, and would not fix the issue of policy disincentives. It added the floor would only benefit one state for the

86 Victorian Department of Treasury and Finance, *Submission 4*, pp. 16–17.

87 Makeham-Kirchner, *Treasury Laws Amendment (Making Sure Every State and Territory Gets Their Fair Share of GST) Bill 2018*, p. 9.

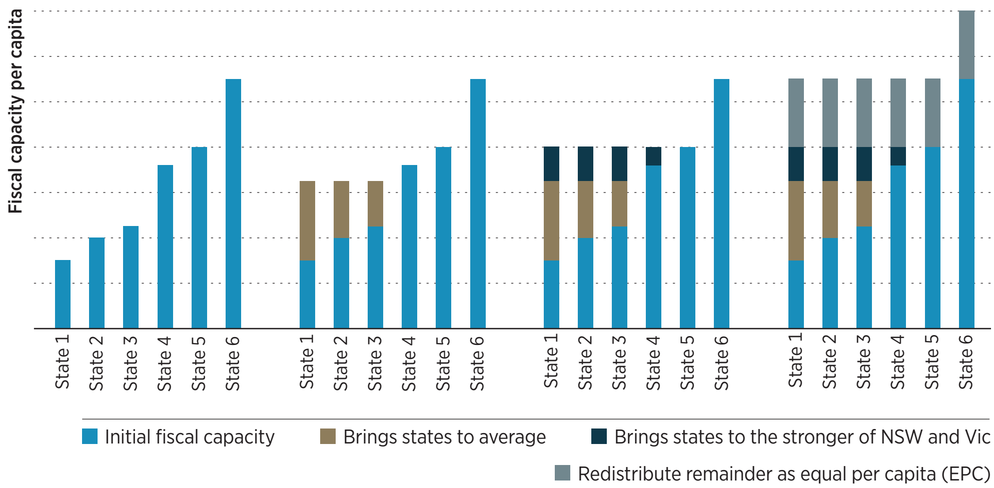
88 Ibid., p. 15.

89 Ibid.

foreseeable future and is a band-aid solution because it doesn't address the efficiency and fairness problems.[90]

The stages of the new equalisation arrangements are depicted in Figure 2.2. The key change from the former arrangements is that states' fiscal capacities are lifted to the stronger of NSW and Victoria rather than to the fiscally strongest state, which lately has been WA. As shown in the figure and as the Victorian DTF states, 'Any state with a fiscal capacity greater than the stronger of NSW or Victoria would retain this advantage post-equalisation.'[91]

Figure 2.2 Stages of the new equalisation process



Source: Adapted from Victorian Department of Treasury and Finance, *Submission 4*, p. 12.

The Australian Government justified its changes to HFE by referring to the volatility caused by the mining boom that required it to give additional funding to WA and the NT to provide services and infrastructure:

> The mining boom was an unprecedented shock to the Australian economy that exposed weaknesses in our system of HFE that could not have been foreseen when the GST was introduced ...
>
> In recent years, to minimise the effects of this extreme volatility in the HFE system, the Government has provided WA with additional funding for much needed road and rail projects that would otherwise have gone unfunded. This year, the Commonwealth also needed to provide the NT with additional funding to assist the NT Government to deliver essential services and infrastructure in response to an almost 20 per cent fall in NT's share of the GST over just two years.
>
> While these 'top-up' GST payments have provided vital short-term relief, they are not a sustainable solution to the volatility we have seen in the HFE system, nor a guard against future economic shocks. In order to reduce volatility in States' shares of the GST

90 Ibid., p. 16; Productivity Commission, *Horizontal fiscal equalisation*, p. 42.

91 Victorian Department of Treasury and Finance, *Submission 4*, p. 12.

> and create certainty, Australia's HFE system needs to be updated to reflect the modern economy.[92]

While the Australian Government acknowledged that some states would be worse off in terms of their GST share under the new arrangements, it stated 'in actual dollars all States are considerably better off than they would have been' due the Government's permanent boosts to the GST pool, adding:

> The size of the boost to the GST pool would be set at a level that ensures no State is worse off as a result of the move to a new equalisation benchmark.[93]

It also argued that on current projections, no state's relativity would fall below 0.75 after 2024–25 under the new equalisation arrangements.[94] However, this projection is based on modelling for only one scenario. According to Deloitte Access Economics, which reviewed the Victorian DTF's modelling of the new equalisation arrangements:

> Our understanding of the analysis undertaken by the Commonwealth is that it only considers a "central case", and that no sensitivity testing has been provided by the Commonwealth. It is on the basis of these central case projections that the Commonwealth has estimated the required amount of top-up payments to ensure that no State is worse off under its proposed system.[95]

Further, Deloitte Access Economics, which is a national economics advisory practice, found:

> alternative scenarios for the broader economy and related tax bases would see State GST relativities differing from the Commonwealth's base case projections for them. These differences could leave some States worse off in dollar terms under the new HFE system. Whether no State is worse off under the new system therefore depends on the accuracy of the Commonwealth's base case projections.[96]

The Tasmanian Department of Treasury and Finance also noted:

> the Commonwealth's proposal includes a number of other recommendations adopted from the PC's report which have not been included in its modelling and will result in Tasmania being worse off than under the current system of full HFE.
>
> A number of these recommendations will significantly advantage the larger States at the expense of the smaller States.[97]

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92 The Australian Treasury, *Productivity Commission inquiry into horizontal fiscal equalisation: Government interim response*, Commonwealth of Australia, Canberra, July 2018, p. 11.

93 Ibid., p. 18.

94 Ibid., p. 20.

95 Deloitte Access Economics, *Report on the Victorian DTF's analysis of the new horizontal fiscal equalisation standard*, Deloitte Access Economics, Canberra, 2018, p. 6.

96 Ibid., p. 2.

97 Tasmanian Department of Treasury and Finance, *Response to the Commonwealth Government's horizontal fiscal equalisation proposal*, Tasmanian Government, Hobart, 2018, p. 4.

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The Victorian DTF informed the Committee that the new equalisation arrangements 'do little to address the issues the PC and Commonwealth Government raised as the main motivations to change the system.'[98] They do not reduce disincentives to major state tax reform and:

> any stability achieved under the new system is expected to only benefit WA, the only State recording a budget surplus, at the cost of equity which is the primary goal of the CGC and the GST system as a whole.
>
> Further, volatility in a State's GST share is offset by volatility in its own revenues—WA receives less GST because it earns more from its own sources of revenue. The effect of this on GST is lagged and so can be predicted in advance. The PC review noted that WA successfully forecast a steep decline in its GST revenues well in advance (Box 2 PC Draft Report p. 10). Sound budget management that accounts for the volatility in own source revenues and flow on effects to GST can alleviate this issue without disrupting HFE.[99]

From an economist's perspective, Mr Murphy told the Committee:

> in terms of economic reform, is a step backwards; it is inferior to the full equalisation model that we used to have …
>
> we have made a step backwards by going away from that towards this system which is really only changed in one way, and that is to give WA a special deal.[100]

FINDING 4: The equalisation arrangements prior to the 2018 legislative changes achieved full fiscal equalisation between Australia's states and territories, but the new arrangements cannot, thus undermining the fundamental intent of horizontal fiscal equalisation.

2.3 The reforms foster inequity between the states

According to the CGC, if the fiscally strongest state receives more GST revenue than it needs to provide the average level of services and it remained the fiscally strongest state over the medium term, it would be able to do one or more of the following:

- provide an above average level of services
- provide higher quality services
- impose lower taxes and charges
- repay its debts faster than other states.[101]

When the Commonwealth proposed the new equalisation arrangements, the states provided their own modelling that showed under a range of scenarios WA, the fiscally strongest state, was likely to gain billions of dollars over the medium term while

98 Victorian Department of Treasury and Finance, *Submission 4*, p. 13.

99 Ibid., p. 14.

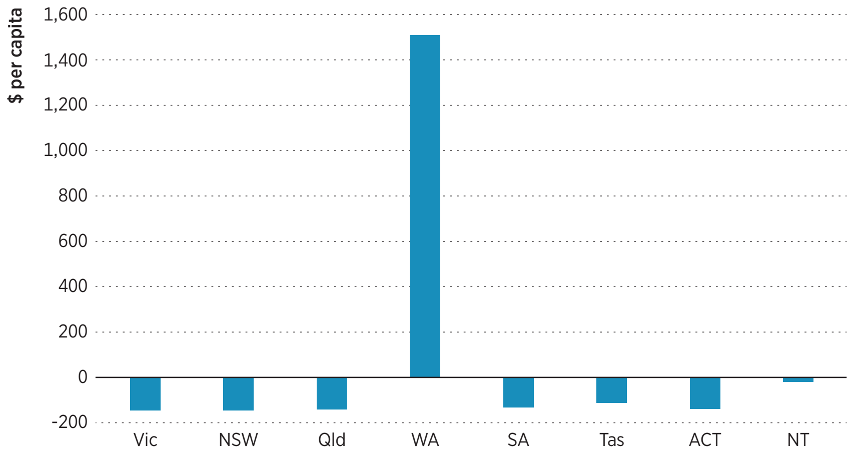
100 Mr Chris Murphy, *Transcript of evidence*, p. 23.

101 Commonwealth Grants Commission, *Submission on the draft report from the Commonwealth Grants Commission*, p. 6.

the other states would lose GST revenue. Some of this modelling and the modelling submitted to the Committee is presented below.

For example, using the ACT Treasury and Economic Development Directorate's indicative modelling for 2021–22 if the new equalisation arrangements were fully implemented and the $850 million boost to the GST pool applied, WA is the clear beneficiary (see Figure 2.3).

Figure 2.3 Indicative per capita change in GST revenue under new arrangements and $850 million boost, 2021–22



Source: Adapted from ACT Government, *Submission 8*, p. 6.

Similar pictures can be seen in other states' modelling. In its response to the Australian Government's proposed equalisation arrangements, the Tasmanian Department of Treasury and Finance modelled several scenarios and found in all of them WA was significantly better off under the new equalisation arrangements when compared with the former arrangements. It stated:

> the single GST scenario modelled by the Commonwealth is only one of many possible scenarios, and it understates the benefits to Western Australia and the financial costs to all other States.[102]

More recent Tasmanian modelling considered the impact of the new equalisation arrangements on the states from 2023–24 to 2031–32 and found most states would be worse off under a range of potential scenarios. For example, modelling of one scenario showed Tasmania would receive $83 million less GST revenue, or $147 less per capita, in 2027–28 when the no-worse-off guarantee has expired, whereas WA would gain $5.6 billion or $1,945 per capita. The modelling also showed Tasmania could lose between $190 million and $755 million by 2031–32 under the new arrangements, while WA could be up to $57.5 billion better off by then.[103]

102 Tasmanian Department of Treasury and Finance, *Response to the Commonwealth Government's horizontal fiscal equalisation proposal*, p. 24.

103 Tasmanian Department of Treasury and Finance, *Occasional Paper: new GST distribution arrangements*, pp. 8, 10; Premier of Tasmania, *Submission 2*, p. 2.

2

The Victorian DTF also presented the Committee with updated modelling of six potential future scenarios in 2027–28, after the no-worse-off guarantee ends. The scenarios, which were deemed by Deloitte Access Economics to be reasonable, included:

- a decline in stamp duty growth for Victoria and NSW
- a decrease in WA's mining royalty revenue
- a replication of the mining boom
- a replication of 2011–12 relativities (when there was strong growth in mining production and high property sales in Victoria and NSW)
- a replication of 2010–11 relativities (when Queensland was the second strongest state)
- a return to 10-year average relativities.[104]

As shown in Table 2.4, Victoria is expected to be worse off under each of these scenarios and its GST revenue losses in 2027–28 could range from $87 million to $1,193 million. Most states were affected negatively by the different scenarios, with Victoria and NSW affected the worst, and only WA gained revenue under each scenario.[105]

Table 2.4 Summary of difference in GST distribution based on prior and new system, 2027–28 ($ million)

Scenario	Vic	NSW	Qld	WA	SA	Tas	ACT	NT
1 NSW and Vic stamp duty growth slows	-216	-274	-142	1,631	-25	-1	-9	26
2 Decrease in WA's mining revenue	-87	-128	-25	1,179	10	11	-1	32
3 Replicate mining boom scenario	-1,193	-1,394	-867	4,855	-266	-74	-72	2
4 Replicate 2011–12 relativities	-213	-235	-158	1,605	-29	-2	-10	32
5 Replicate 2010–11 relativities	-501	-589	97	2,119	-102	-25	-28	20
6 Relativities return to 10-year average	-1,020	-1,219	-763	4,343	-228	-60	-61	-2

Source: Victorian Department of Treasury and Finance, *Submission 4*, p. 21.

In the first year of the new equalisation arrangements, states other than WA have voiced their concerns about the fiscal disparities created by the new equalisation arrangements. For example, Tasmania stated:

104 Victorian Department of Treasury and Finance, *Submission 4*, pp. 19–20; Deloitte Access Economics, *Report on the Victorian DTF's analysis of the new horizontal fiscal equalisation standard*, p. iii.

105 Victorian Department of Treasury and Finance, *Submission 4*, p. 20.

> The inequity embedded in the new GST distribution is rapidly becoming apparent.
>
> The 2021–22 Australian Government Budget forecasts that all states, except Western Australia and the Northern Territory, will be worse off under the new arrangements across the Forward Estimates …
>
> This is largely attributable to the rapid growth in Western Australia's mineral royalties since 2017–18.[106]

The main concerns of states other than WA were that their residents would be disadvantaged due to less funding to deliver government services and infrastructure.[107] According to Tasmania, the implications of this inequity are that:

> disadvantaged States would not have the capacity to compensate for their disadvantages and stronger States would have a greater capacity than required to meet their needs.
>
> Through the fortunate abundance of natural resources, Western Australia was able to take advantage of world demand for these minerals and reap the unprecedented economic benefits. As a result, Western Australia has had, and will continue to have, extremely high royalty revenues compared to other States.
>
> However, this boom came at the expense of other State economies. Tasmania, for instance, experienced the downside effects of the very high exchange rates on its own exports. In addition, the mining boom drove significant wage increases in the public sector, impacting on service delivery costs in a number of States.[108]

The Government of SA echoed these sentiments:

> The new system effectively says that people who reside in Western Australia deserve much better hospitals, schools and other government services than other Australians simply because a large proportion of Australia's valuable mining resources happen to be located within their borders—and because States are responsible for mining royalties. Other states also have to respond to some of the exchange rate implications (high cost of exports) caused when there is high demand for mineral resources sourced from Western Australia.
>
> …
>
> This fiscal disparity between states will reduce economic efficiency and overall living standards across the Federation.
>
> For example, with a lower GST share due to the new arrangements, a state with a higher proportion of residents who use more government services (e.g. older people) would need to reduce the standard of government services or increase its taxes to be able to maintain current services. Over time, skilled labour and capital would migrate out of that

106 Tasmanian Department of Treasury and Finance, *Occasional Paper: new GST distribution arrangements*, p. 8.

107 Victorian Department of Treasury and Finance, *Submission 4*, p. 13; ACT Government, *Submission 8*, p. 7.

108 Tasmanian Department of Treasury and Finance, *Response to the Commonwealth Government's horizontal fiscal equalisation proposal*, p. 2.

> state to Western Australia to take advantage of its lower taxes and/or higher standard of services, despite potentially being less productive in Western Australia. Alternatively, a Western Australian worker may choose to remain in Western Australia despite being more productive in another state.
>
> The CGC has noted that the movement of people to jurisdictions where their productivity is lower, or where they impose additional costs on existing residents, would result in a net loss in economic efficiency and living standards for Australia as a whole.[109]

Mr Murphy agreed that the new equalisation arrangements would 'result in a less efficient allocation of labour between states.'[110] SA argued this inequity would not occur if Australia had a unitary system of government because in this situation the Government would use mining royalty revenue to improve services or reduce tax for all Australians rather than just for residents in the region where the minerals were mined.[111]

According to Mr Eslake, Australia's success in equalising states' fiscal capacities under the former arrangements:

> means that the quality of education, health and other state-type services that the people in Australia's poorest states receive is not significantly worse than those received by people who happen to live in Australia's richest states.[112]

The new arrangements 'unpick that longstanding principle … that has over time made an important contribution to us being a less unequal place than we would have otherwise been.'[113]

States other than WA argued that the new arrangements entrench a gap between them and WA, necessitating the continuation of the no-worse-off guarantee beyond 2026–27. Even with this guarantee, WA will still have an ongoing fiscal advantage over other states.[114]

2.3.1 The reforms are a win-win outcome for Western Australia

WA argued that without the new equalisation arrangements, it would receive only 17% of its population share in GST revenue in 2022–23 and 10% in 2023–24 and even when the relativity floors are applied it will receive less than its population share.[115] However, other stakeholders argued the billions of dollars WA raises in mining royalty revenue compensates for this. For example, SA stated:

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109 Government of South Australia, *Submission 10*, pp. 6–7.

110 Mr Chris Murphy, *Transcript of evidence*, p. 21.

111 Government of South Australia, *Submission 10*, p. 4.

112 Mr Saul Eslake, *Transcript of evidence*, p. 11.

113 Ibid.

114 ACT Government, *Submission 8*, p. 7; Government of South Australia, *Submission 10*, p. 2; Tasmanian Department of Treasury and Finance, *Occasional Paper: new GST distribution arrangements*, pp. 7, 11.

115 Western Australian Department of Treasury, *Submission 7*, p. 7.

> In 2019–20, Western Australia collected $8.5 billion in mining revenue. This accounted for around 55 per cent of mining revenue nationally, despite only having around 10 per cent of the national population.[116]

Mr Eslake noted:

> from the early 2000s onwards, through no great effort on its own part, Western Australia became the richest state in the nation by a margin that for most of the last 15 years has been much bigger than the margins by which Victoria or New South Wales had previously been the richest states in the nation.
>
> As a result, Western Australia began for the first time to get a smaller share of its revenue from the GST than it would have obtained from a notional per capita distribution of GST revenues, something which had never bothered Western Australia when it got a larger share of those revenues than its share of the population would have entitled it to.[117]

According to Mr Broomfield from the Victorian Chamber of Commerce and Industry:

> one may have had some sympathy for Western Australia if not for the fact that their improved revenue position outside of GST is primarily a consequence of just digging stuff up and not really value adding substantially with other states then able to leverage off that. You would probably be able to better understand it if that was the case, if there was sort of a hand up for the states as opposed to just simply digging stuff up and exporting it away.[118]

The Samuel Griffith Society, which undertakes and supports research on Australia's constitutional arrangements, added:

> There is nothing inherently wrong with WA receiving a fairer share of the GST revenue that [it] raises. But for a system which claims to redistribute revenue based on 'need' this appears to be a significant failure.[119]

In 2018, the PC acknowledged WA's fiscal strength and the likelihood WA would continue to be the fiscally strongest state for the foreseeable future. It used this to justify the equalisation changes, but stated WA should set up measures to deal with GST revenue volatility:

> Western Australia still remains the fiscally strongest State—its mining royalties are about three and a half times higher now than they were before the mining boom. Indeed, the higher level of mining production in Western Australia is expected to continue for the foreseeable future, indicating a more enduring change, rather than a transitory change, in its revenue fortunes. This is an important factor when it comes to assessing the case for change. It strongly suggests that ad hoc top-ups are not an enduring solution.

116 Government of South Australia, *Submission 10*, p. 5.

117 Mr Saul Eslake, *Transcript of evidence*, p. 8.

118 Mr Dylan Broomfield, *Transcript of evidence*, p. 24.

119 The Samuel Griffith Society, *Submission 9*, p. 4.

> Western Australia's experience has been unprecedented, exacerbated by earlier budget decisions of the WA Government. For States with less extreme changes in fiscal capacity, limited contemporaneity has been less problematic, and indeed most other States prefer an emphasis on stability (particularly as GST payments are on average less volatile than other State revenue sources).
>
> … The most effective response to a lack of contemporaneity lies with the States themselves. States have a range of methods, including borrowing and saving, by which they can manage gaps between their GST needs and actual payments, as they already use for other sources of budget volatility.[120]

Mr Murphy agreed that WA should be able to manage the volatility, stating:

> it is certainly true that iron ore prices are volatile, but the equalisation system already takes care of that. So if iron ore prices are high, WA contributes into the pool. If they are not, they contribute less—or in the past they have even been recipients at times. So the system sort of automatically adjusts for that. It does smooth things out by using this three-year average, as you probably know, so basically it allows for all of that with a lag. So WA just has to manage its finances to allow for that lag, and it should not really be an issue.[121]

Each of the economists who gave evidence to the Committee noted how much the new arrangements benefit WA at the expense of the other states. For example, Mr Eslake said:

> For Western Australia the deal imposed by the Morrison Government on the states and territories three years ago is the equivalent of what Chinese President Xi Jinping would call a win-win outcome …
>
> it does not matter what happens to the iron ore price, which is the principal determinant of Western Australia's fiscal capacity, Western Australia wins.
>
> If the iron ore price goes up or stays high, Western Australia gets to keep a much bigger share of those resulting mineral royalty revenues than it would have done under the previous arrangements or that New South Wales, for example, might have done if by chance the iron ore had been at Broken Hill rather than under the Pilbara. But if the iron ore price goes down and stays down, Western Australia's share of GST revenue rises, as it would have done under the existing arrangements.[122]

This was echoed by Mr Murphy:

> WA wins both ways, because if WA were to get to a situation where its fiscal position was very weak again—you know, iron ore prices got very low, for example—it could become a recipient state again. But what it cannot become is a big donor state, because of the change in the rule. It is like heads WA wins, tails all the other states lose. So it is an asymmetric system.[123]

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120 Productivity Commission, *Horizontal fiscal equalisation*, p. 11.

121 Mr Chris Murphy, *Transcript of evidence*, p. 22.

122 Mr Saul Eslake, *Transcript of evidence*, p. 9.

123 Mr Chris Murphy, *Transcript of evidence*, p. 22.

Dr Jackson stated that while states other than WA acknowledge the need to address the equity implications of the new arrangements:

> that is not to say that Western Australia does not have some case to play, but clearly they benefit disproportionately from higher iron ore revenues; that is something that supports their budget considerably. Yes, they need support to maybe manage some of the ups and downs of that—and whether or not there need to be specific Commonwealth levers in place, so that where iron ore prices do drop dramatically there can be emergency support to support the Western Australian Government definitely I think is something probably the other states would be open to. But I think to set the whole system up on the basis of that does create these inequities, and it does mean that states like Victoria are going to be worse off.[124]

In its submission, the WA Department of Treasury claimed that iron ore prices are likely to return to their long-run average since recent high prices could be explained by 'temporary supply constraints in Brazil and COVID-19-related stimulus measures in China.'[125] If this occurred, WA expects all states would be better off under the new equalisation arrangements even when the no-worse-off guarantee ends due to the Commonwealth's boost to the GST pool. It added that Victoria's modelling assumed higher iron ore prices than those projected in both the Western Australian and Australian budgets thus questioning the validity of its modelling.[126]

In response, Mr Martine from the Victorian DTF argued:

> We have obviously read the WA submission, and I do note that they make the statement that under the new system everyone is going to be better off but they do not really back it up with much analysis or modelling. That is one of, I guess, our criticisms, going back to 2018, of where the Commonwealth were out trying to persuade us all that we are all going to be better off. I mean, I recognise that modelling over the longer term and medium term is always difficult and you do need to make assumptions. But just as the assumptions have proved to be very much incorrect from 2018, which is only three years ago—it is not a long time—the point that the WA submission tries to make is that they believe two things: firstly, that iron ore prices will return to their long-run average, which is about US$66 a tonne … and secondly, they argue that in the long-run average we are all better off.
>
> There are two problems with that. Firstly, the assumption that we are going to return to a long-run average—currently, as of today, iron ore is sitting at US$107 a tonne, so WA is sort of arguing that we are going to get it back to US$66 in the next financial year, which is a pretty bold assumption to make, which we just do not think is going to happen. Secondly, even if iron ore prices got back to their long-run average, which is around that US$65, US$66 a tonne, we still think that all states will be worse off. That scenario in the slides that we provided is effectively what we describe as scenario 2. Even under that scenario, even if in the long run we go back to US$65, US$66 a tonne, we would be estimating we are $87 million a year worse off, which is getting up to $400 million over

124 Dr Angela Jackson, *Transcript of evidence*, pp. 14–15.

125 Western Australian Department of Treasury, *Submission 7*, p. 8.

126 Ibid., p. 9.

> the budget and forward estimates, so still pretty significant. But that assumes you get back to that US$65, US$66, which, given we are at US$107 as of today, is a pretty big move in iron ore prices.[127]

The evidence overwhelmingly indicates that WA is the primary beneficiary of the new equalisation arrangements, gaining billions of dollars of GST revenue, whether iron ore prices increase or decrease. During the transition period, the Commonwealth will compensate other states for their loss of GST revenue through the no-worse-off guarantee payments. However, when the no-worse-off guarantee ends, the states other than WA will have to bear the cost of increasing WA's GST share. WA's ongoing gain and the other states' ongoing loss of GST revenue under the new equalisation arrangements will entrench inequity between the states.

FINDING 5: Western Australia will gain billions of dollars of revenue from the new equalisation arrangements despite being the fiscally strongest state for the foreseeable future. When the no-worse-off guarantee ends, the increase to Western Australia's GST share at the expense of the other states and territories will entrench inequity between the states.

2.4 The reforms impose a financial burden on all Australians

When the Australian Government announced the new equalisation arrangements and declared all states would be better off, it based its position on state GST relativity forecasts in the PC's 2018 inquiry into HFE. Using these forecasts, it estimated the cost of the no-worse-off guarantee payments would amount to $3.7 billion between 2019–20 and 2023–24. However, it is now clear that the PC overestimated WA's GST relativities since it assumed they would increase each year and even hit 0.76 by 2026–27, thus eliminating the need for implementing the relativity floor that year.[128]

Instead, due to significant increases in the iron ore price, WA's GST relativity has decreased and is significantly below the floor (equalling 0.33 in 2021–22 under the former equalisation arrangements and 0.42 under the current arrangements). At the same time, the fiscal circumstances of states other than WA have changed due to the impact of the COVID-19 pandemic, thus the forecasts underpinning the new arrangements have proved inaccurate.[129]

The 2021–22 Australian Government Budget forecasts the no-worse-off guarantee payments will cost the Commonwealth $7.6 billion between 2021–22 and 2024–25.[130] Of this, Victoria will receive $2.3 billion.[131] The forecast no-worse-off guarantee payments

127 Mr David Martine, *Transcript of evidence*, p. 22.

128 Government of South Australia, *Submission 10*, p. 7.

129 Ibid., p. 6.

130 The Australian Treasury, *Australian Budget 2021–22 Paper No. 3: federal financial relations*, Canberra, 2021, p. 100.

131 Mr David Martine, *Transcript of evidence*, p. 18.

payable to each state over the budget and forward estimates period are presented in Table 2.5.

Table 2.5 Australian Government forecast no-worse-off guarantee payments, 2021–22 to 2024–25 ($ million)

	Vic	NSW	Qld	WA	SA	Tas	ACT	NT
2021–22	47.0	52.2	24.1	0.0	0.0	0.0	1.2	0.0
2022–23	701.4	838.4	529.1	0.0	164.5	36.6	42.2	0.0
2023–24	735.8	872.8	553.3	0.0	171.7	44.6	43.9	0.0
2024–25	844.3	992.0	626.5	0.0	189.5	46.5	49.2	0.0
Total	**2,328.5**	**2,755.4**	**1,733.0**	**0.0**	**525.7**	**127.7**	**136.6**	**0.0**

Source: Tasmanian Department of Treasury and Finance, *Occasional Paper: new GST distribution arrangements*, Tasmanian Government, Hobart, 2021, p. 8.

According to Mr Martine:

> Western Australia has access to very strong mining royalties, which is one reason why they are the only state or territory in the country that managed to produce a surplus budget in the middle of the biggest economic downturn since the Great Depression—because they had access to very strong mining royalties and the GST payments that started to flow through, the extra top-up payments. So that is really the main driver as to why the forecasts were wrong, and it was obvious to all of us at the time. Like any long-run forecasts, you only need minor things to change for the forecast to be proved wrong.[132]

As the Premier of Tasmania outlined, in 2021, the Australian Government forecast the cost of the new arrangements to the Commonwealth including top-up payments, pool boosts and no-worse-off guarantee payments to be $15.6 billion between 2019–20 and 2024–25, which exceeds the original estimate of $4.6 billion.[133] According to the NSW 2021–22 Budget statement, ‘This is contributing to the Commonwealth’s own deficit at a time when these dollars could have been better spent on productivity-enhancing reforms that support the post-pandemic recovery.’[134]

Similar sentiments were shared by the Government of SA, which stated:

> This is money directed to Western Australia that could be used to fund nationally significant reforms or further support businesses and communities across Australia. At a time when other jurisdictions and the Federal Government are running significant budget deficits to support the economy during COVID-19, strong iron ore prices and the changes to the distribution of GST have resulted in Western Australia recording a record

132 Ibid., p. 19.

133 Premier of Tasmania, *Submission 2*, p. 1.

134 New South Wales Treasury, *New South Wales Budget 2021–22 Paper No. 1: Budget statement*, Sydney, 2021, p. 4.14.

> $5.8 billion budget surplus in 2020–21, with further large surpluses expected in future years. This is clearly an absurd outcome.[135]

Mr Eslake strongly agreed, arguing:

> All Australian taxpayers—including those living in Victoria—should be appalled that the Commonwealth Government will be incurring more debt (to be serviced, and ultimately repaid, by future generations of Australian taxpayers) in order to transfer billions of dollars to the government of the richest state in Australia, the only government in Australia (and one of very few anywhere in the world) which is currently running, and expects for the foreseeable future to be running, budget surpluses.[136]

The cost of the new equalisation arrangements to the Commonwealth, which is forecast to exceed the original estimate by over $11 billion, will add to the growing Australian budget deficit and be ultimately funded by Australian taxpayers.[137] These costs could be even greater if iron ore prices rise higher than expected and WA's fiscal capacity improves even more.

FINDING 6: The Australian Government significantly underestimated the costs of the new equalisation arrangements, which are forecast to add an additional $11 billion to the Australian budget deficit by 2024–25.

2.5 The no-worse-off guarantee must continue until issues with the reforms are addressed

This chapter has outlined how the Commonwealth's reforms to GST distribution have a negative impact on Victoria. The new equalisation arrangements will reduce Victoria's GST revenue, costing it up to $1.2 billion in 2027–28 when the no-worse-off guarantee will have expired. The legislated PC review of the new arrangements in 2026 is set to consider whether the new equalisation arrangements are operating efficiently, effectively, and as intended. However, the timing will be too late for state governments to plan their future budgets, as explained by Mr Martine:

> While 2026 does seem a long way off, from a budgeting point of view it is not. So that is why it is important to review the system, and that is why all states and territories other than Western Australia are pushing now to have the guarantee issue dealt with. Because all of our budgets are four years, so it will not be long before the years 2026–27 and 2027–28 start appearing in our budget papers, and we need to know now the Commonwealth's position.[138]

The Victorian and other state governments have asked the Australian Government to bring forward the PC review, but they have been unsuccessful. In response the

135 Government of South Australia, *Submission 10*, p. 7.

136 Mr Saul Eslake, *Submission 1*, p. 14.

137 Mr Saul Eslake, *Transcript of evidence*, p. 9.

138 Mr David Martine, *Transcript of evidence*, pp. 20–21.

SA Treasurer announced that his state will conduct its own review, which has support from Victoria, NSW and other states. The Victorian DTF is assisting the SA review with modelling and it is expected the review will be publicly released before the SA election scheduled for March 2022.[139]

Mr Eslake recommended the states push for the 2026 PC review to be conducted earlier. In addition, he argued the states should demand to have some input into the terms of reference and who conducts the inquiry.[140]

Many stakeholders supported a return to the former equalisation arrangements with some suggesting separate Commonwealth support for WA outside of GST distribution.[141] However, if this is not possible, the states should demand the Australian Government make the no-worse-off guarantee permanent or continue it until the concerns with the new equalisation arrangements are addressed.[142] The Government of SA argued the no-worse-off guarantee be continued beyond 2026–27:

> while further work is undertaken to address the fundamental problems with the new arrangements. Continuing the guarantee alone without addressing the issues raised … would still lower national living standards and provide an ongoing fiscal advantage to Western Australia relative to other jurisdictions.[143]

While Dr Jackson supported reverting to the previous arrangements because they were more equitable, she added the former system:

> created problems for Western Australia, particularly with the volatility in the iron ore price, and I understand that, and I think that is whether you have a mechanism in place to allow for quicker adjustment, particularly if you are only adjusting over three years, which obviously has benefits in other cases but for Western Australia it creates specific concerns because it means their budget is very volatile in terms of the iron ore price. But I think you can create a mechanism, whether it is an 'If you have more than this within a year change in revenue due to—then we will provide emergency assistance' type of arrangement, to provide that smoothing so that individual states are not necessarily open to that volatility.[144]

She also supported broader tax reform, such as introducing a form of wealth taxes such as inheritance tax, which would allow:

> the Commonwealth to reduce income taxes and reduce its support potentially for states, giving states more agency over their revenue going forward and a more secure revenue base going forward as well …[145]

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139 Ibid., pp. 20, 21.

140 Mr Saul Eslake, *Transcript of evidence*, p. 10.

141 For example, Premier of Tasmania, *Submission 2*, p. 2; Victorian Department of Treasury and Finance, *Submission 4*, p. 2; Mr Saul Eslake, *Transcript of evidence*, p. 10; Dr Angela Jackson, *Transcript of evidence*, p. 15; Mr Chris Murphy, *Transcript of evidence*, p. 23.

142 Mr Saul Eslake, *Submission 1*, p. 15; Victorian Department of Treasury and Finance, *Submission 4*, p. 2; ACT Government, *Submission 8*, p. 8; Government of South Australia, *Submission 10*, p. 8.

143 Government of South Australia, *Submission 10*, p. 8.

144 Dr Angela Jackson, *Transcript of evidence*, p. 15.

145 Ibid.

There is also capacity for states to reform land tax and payroll tax, but this would need support from the Commonwealth and tax reform across the board, so states willing to reform do not lose revenue streams that other states hold on to.[146]

In the meantime, the immediate risk to Victoria and states other than WA is the expiration of the no-worse-off guarantee, which will result in the loss of significant amounts of GST revenue after 2026–27. If the GST distribution reforms cannot be wound back, the Victorian and similarly affected state governments should advocate that the Australian Government continue the no-worse-off guarantee until issues with the new equalisation arrangements can be resolved. The states should also demand the PC review be held as soon as possible so that states can base their budgetary planning on the outcomes of this review.

RECOMMENDATION 1: That the Victorian Government work with other adversely affected states and territories to advocate that the Australian Government revert to the former equalisation arrangements for GST revenue distribution.

RECOMMENDATION 2: That the Victorian Government work with other adversely affected states and territories to advocate that the Australian Government extend the no-worse-off guarantee beyond 2026–27 until the inequity created by the new equalisation arrangements is addressed.

RECOMMENDATION 3: That the Victorian Government work with other adversely affected states and territories to advocate that the legislated Productivity Commission review, or another independent review, of the new equalisation arrangements be conducted as soon as possible with input from the states on the review's terms of reference.

146 Ibid., p. 16.

3 How the Commonwealth could support Victoria better

In addition to the fall in Victoria's GST share, stakeholders raised concerns about other areas where they believed the Commonwealth could better support Victoria, such as through more infrastructure investment, local government assistance and help to recover from the economic impacts of the COVID-19 pandemic. Some of these concerns are long standing, as mentioned by Mr Dylan Broomfield, General Manager of Policy and Advocacy at the Victorian Chamber of Commerce and Industry, which represents and supports Victorian businesses. He told the Committee:

> recent engagement with our members through surveys and round tables has shown that they are acutely aware that they are not getting a fair deal. With a lot of our members, the vitriol with which they have been discussing, with us, the Commonwealth has increased dramatically in the last nine months. But I think more broadly there is a perception that it is not just in the last nine months, it is in the last more or less 10 to 15 years that they feel that Victoria has not been getting a fair deal from the Commonwealth, and I think there is at the moment a large appetite for this to be rectified.[1]

Before this chapter covers issues with Commonwealth support to Victoria during the COVID-19 pandemic, it looks at longer term concerns such as Commonwealth investment in Victorian infrastructure and Commonwealth support for local government.

3.1 Commonwealth investment in Victorian infrastructure should be fairer and more consultative

The Committee heard that Victoria gets less than its fair share of infrastructure investment from the Commonwealth. According to independent not-for-profit policy research institute, The McKell Institute Victoria:

> Put simply, Victoria is often the forgotten cousin of all states and territories when it comes to infrastructure investment by the Commonwealth. Our state is consistently underfunded on a population basis, and then what funding is promised is often under-delivered.[2]

Infrastructure refers to assets that provide, or enable the provision of, services that are essential to the operation of society, such as electricity, water, schools, roads and hospitals. Investment in infrastructure benefits the state socially and economically by

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1 Mr Dylan Broomfield, General Manager, Policy and Advocacy, Victorian Chamber of Commerce and Industry, public hearing, Melbourne, 15 December 2021, *Transcript of evidence*, p. 25.

2 The McKell Institute Victoria, *Submission 5*, p. 1.

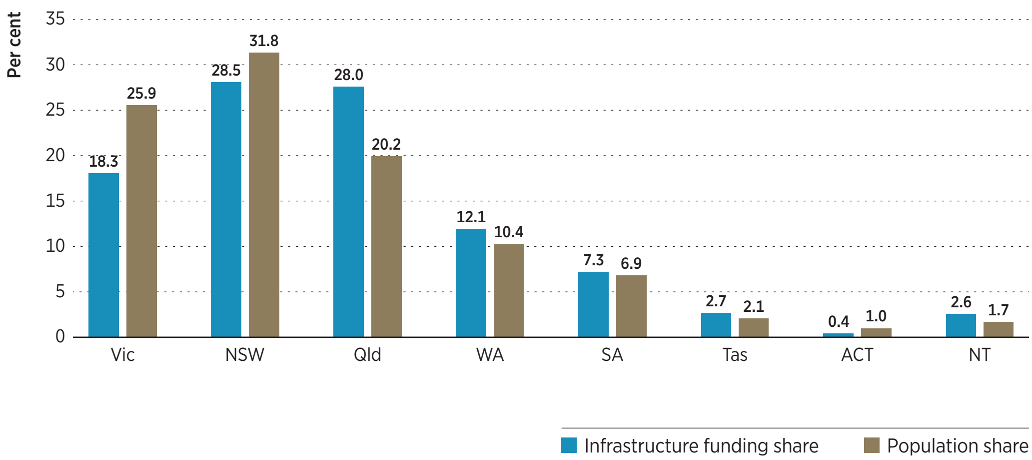
creating jobs and capital, which in turn improves productivity and promotes long-term economic growth.[3]

Stakeholders noted that in 2020–21, Victoria received 18.3% of total Commonwealth infrastructure payments to the states despite its population share of 25.9%.[4] This funding gap of 7.65% equated to $745 million in infrastructure funding.[5]

In addition, Victoria received a very small proportion of funding from specific Commonwealth infrastructure programs in 2020–21. For example, it received just 2.6% of funding from the Roads of Strategic Importance program, an initiative to connect regional businesses to local and international markets and to better connect regional communities. Victoria also received only 5% of funding from the Heavy Vehicle Safety and Productivity program, which funds infrastructure projects that improve the productivity and safety outcomes of heavy vehicle operations across Australia. This is despite the Port of Melbourne being the busiest container port in Australia requiring most of this freight to be transported on Victorian roads to reach its destination.[6]

Figure 3.1 compares the proportion of Commonwealth infrastructure funding each state and territory (hereafter state) received in 2020–21 and compares it with each state's population share. Victoria and the Australian Capital Territory (ACT) received significantly less infrastructure funding than their population share and New South Wales (NSW) received three percentage points less. In contrast, the other states received more than their population share, with Queensland receiving almost eight percentage points more.[7]

Figure 3.1 **Commonwealth infrastructure funding share by jurisdiction and population share, 2020–21**



Source: The McKell Institute Victoria, *Submission 5*, p. 3.

3 Mr Ryan Batchelor, Executive Director, The McKell Institute Victoria, public hearing, Melbourne, 15 December 2021, *Transcript of evidence*, p. 1.

4 The McKell Institute Victoria, *Submission 5*, p. 2; Mr Dylan Broomfield, *Transcript of evidence*, p. 24.

5 The McKell Institute Victoria, *Submission 5*, p. 2.

6 Ibid.

7 Ibid., p. 3.

This underfunding is set to continue according to the Victorian Department of Treasury and Finance (DTF). It noted Victoria is estimated to receive 22% of Commonwealth infrastructure investment over the five years to 2023–24, which equates to a $4.2 billion shortfall when compared with population share.[8] Using more recent figures, Mr David Martine, Secretary of the Victorian DTF, stated:

> if you look at the period 2020–21 to 2024–25, so for that five-year period, based on the current Commonwealth commitments, we are only receiving 21.5%, so it is nearly five percentage points less than our population share. Pretty much every other state—in fact, every other state and territory other than the ACT—is receiving greater than their population share or close to their population share. So New South Wales, for example, their population share is 31.5%. They are receiving 31.1%. So they are pretty well on population.
>
> Other states are receiving more than their population share: so Western Australia, for example, their population share is 10.4%. They are receiving 12.9% of Commonwealth infrastructure funding over that five-year period. South Australia is above their population share, Tasmania is a little bit above, Queensland is above as well and the Northern Territory is significantly above. Traditionally we have been receiving less than our population share, so our current [Victorian] Treasurer—you would have heard him publicly on many occasions make this point, and it has been made by him as well in most budget papers. We continue to lobby the Commonwealth to try and get more of our share, because five percentage points is reasonably significant.[9]

One of the stated reasons why Victoria receives less infrastructure funding than its population share is its smaller size and therefore fewer kilometres of roads. However, this does not account for the scale of underfunding according to Executive Director of The McKell Institute Victoria, Mr Ryan Batchelor, who noted the Commonwealth Grants Commission, which determines states' GST revenue shares, considers geography and topography in its calculations and does not underfund Victoria to the same extent.[10]

Mr Broomfield noted continued underfunding for Victorian infrastructure will have an impact on future infrastructure projects and productivity:

> It has been reasonably plain to see that the allocation of funding for infrastructure has not been as equal as it could be to Victoria. Now, it is not to the point where we need population to line up exactly with infrastructure spending, because we do accept that we are not as large a state, but the gap that has started to emerge recently is something that really needs to be resolved, because if it is not, then we are just not going to have the capacity to deliver not just the current infrastructure to projects that are going on but further infrastructure projects that would be able to lead to greater efficiency for business so that they can be more productive and more effective.[11]

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8 Victorian Department of Treasury and Finance, *Submission 4*, p. 4.

9 Mr David Martine, Secretary, Department of Treasury and Finance, Victoria, public hearing, Melbourne, 15 December 2021, *Transcript of evidence*, p. 22.

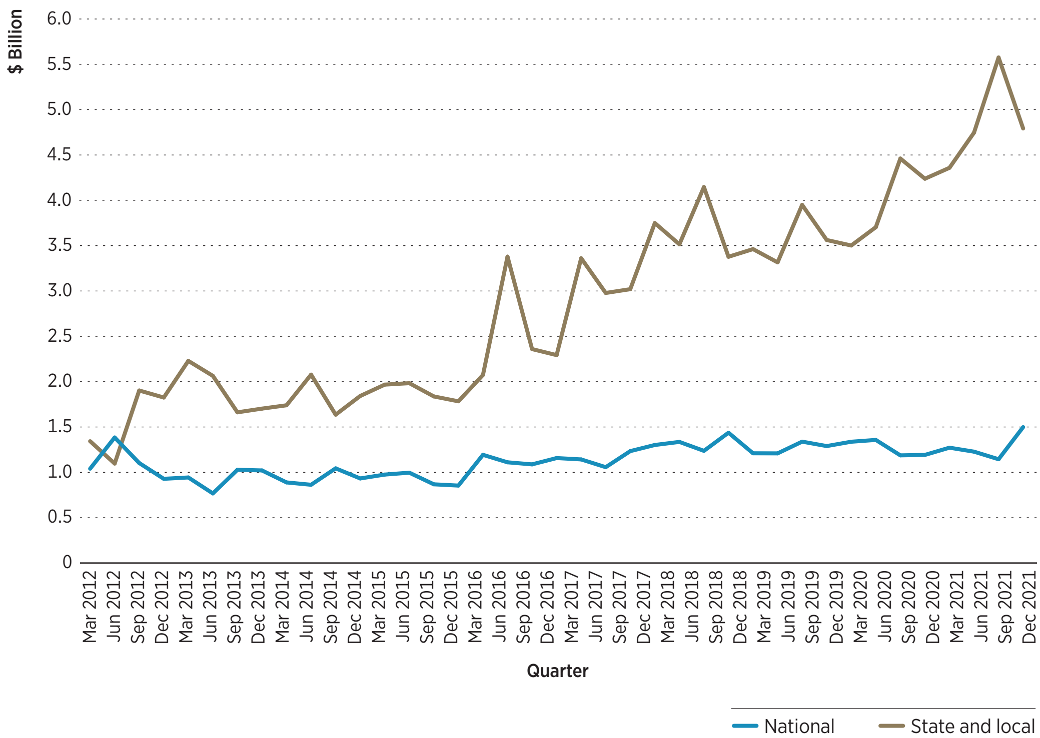
10 Mr Ryan Batchelor, *Transcript of evidence*, p. 3.

11 Mr Dylan Broomfield, *Transcript of evidence*, p. 26.

3

The McKell Institute Victoria also noted Australian National Accounts data from the Australian Bureau of Statistics show capital investment in Victoria by the Commonwealth has stayed constant over the past decade at around $1 billion to $1.5 billion whereas investment by the Victorian Government has more than doubled since late 2015. In the June 2021 quarter, the Victorian Government invested $5.275 billion in public capital formation compared with $1.068 billion of Commonwealth investment in Victoria.[12] Figure 3.2 shows the gap between Victorian and Commonwealth public capital investment has grown over the past decade.

Figure 3.2 Public capital formation in Victoria by level of government, 2012 to 2021[(a)]



a. Seasonally adjusted general government chain volume measures.

Source: Australian Bureau of Statistics, Table 27, *Australian National Accounts: national income, expenditure and product*, December 2021, <https://www.abs.gov.au/statistics/economy/national-accounts/australian-national-accounts-national-income-expenditure-and-product/latest-release#data-download> accessed 19 January 2022.

Victorian Government infrastructure spending 'has acted as an important economic ballast' during the COVID-19 pandemic according to The McKell Institute Victoria. In its analysis of Victorian Government infrastructure investment, it found the state's infrastructure pipeline softened the pandemic's impact on the Victorian economy. Its modelling compared the impact on the economy if state government infrastructure spending remained at pre-2014 levels compared with actual state government investment. Had the pre-2014 approach continued, Victoria's economy would have shrunk by 0.8% between December 2019 and June 2021 and only grown by 0.7% in the June 2021 quarter (compared with actual growth of 1.4%).[13]

12 The McKell Institute Victoria, *Submission 5*, p. 3.

13 Ibid., p. 5.

As explained by Mr Batchelor:

> without the State Government's infrastructure investment pipeline, the recession in Victoria last year would have been twice as bad as it was and that during the pandemic not only did the state's infrastructure investment keep rising, we found that the Commonwealth's infrastructure investment actually went backwards. So in this hour of need, so to speak, the state's infrastructure investment was really critical in pulling the state through, in softening the load.[14]

The McKell Institute Victoria also identified a delivery gap in Victorian infrastructure spending when it compared Commonwealth Budget estimates and outcomes. Of the $1.87 billion in infrastructure payments promised to Victoria in the 2020–21 Commonwealth Budget, only $1.78 billion was delivered according to the Final Budget Outcome released in September 2021. This delivery shortfall of $89 million was mirrored by a $45 million shortfall in 2019–20 and a $189 million shortfall in 2018–19.[15]

Mr Batchelor acknowledged these delivery gaps were not unique to Victoria, stating:

> All of the states and territories in the last year received less funding than they were promised, so it is a general problem with the delivery of Commonwealth infrastructure spending compared to what they promised they would do. So there are clearly some systemic issues in the administration of Commonwealth programs designed to support infrastructure in all of the states and territories, which is clearly falling behind … we see it as a common problem, but it is relevant to Victoria. I think it would be probably excusable if it was just a one-off, but given it is a repeated problem we think it is probably something that needs to be looked at.[16]

Stakeholders called for a more transparent and consultative approach to Commonwealth investment in state infrastructure. For example, economist and Principal of Corinna Economic Advisory, Mr Saul Eslake, argued:

> Federal Government funding for infrastructure ought to be based on arms-length, transparent, publicly released business cases ranked according to the economics and, if it is possible to calibrate them, social benefits, and if that happens to result in some states getting a bigger share of Commonwealth capital funding than, for example, their population or GDP [Gross Domestic Product] shares would warrant, then I am not necessarily troubled by that if it is clear that more projects with higher rates of return are located in some states than others. But unfortunately Infrastructure Australia has not been used in that way. The business cases for a number of high-profile Commonwealth-funded projects, most obviously the inland rail, have never been publicly released and so it is not possible for outside observers such as me to make an informed judgement as to whether the distribution of capital funding across states and territories accords with an arms-length, independent ranking of those projects by their net economic and social benefit.[17]

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14 Mr Ryan Batchelor, *Transcript of evidence*, p. 2.

15 The McKell Institute Victoria, *Submission 5*, p. 4.

16 Mr Ryan Batchelor, *Transcript of evidence*, pp. 3–4.

17 Mr Saul Eslake, Economist and Principal, Corinna Economic Advisory, public hearing, Melbourne, 10 December 2021, *Transcript of evidence*, p. 10.

Mr Batchelor added that the delivery of infrastructure projects would be improved through better consultation between advisory bodies Infrastructure Australia and Infrastructure Victoria:

> part of the problem is in the planning and that there just needs to be, across the board, a better integration of Commonwealth infrastructure planning and Victorian infrastructure planning so that the delivery can actually occur. I think you do see examples of where the Commonwealth and the state work together to get something done. Although it has not fully started yet, it looks like the airport rail link is going to be a good example of that, where … a lot of effort that has gone into the work up front where there is a common goal, a common objective, alignment of interests and the project itself is of mutual importance and you can actually get it delivered.
>
> … sometimes—we all know how politics works—projects get announced for a range of reasons, not because they are the most urgent, the most important or where the delivery timetable is assured. I think that does lead to these kinds of delivery and delay problems, and particularly on the transport networks the management of infrastructure projects is actually very complicated because of the sequencing and planning. That is why organisations like Infrastructure Victoria and Infrastructure Australia have an incredibly important job in providing long-term guidance and advice on what the pipeline should look like …
>
> often the work is not done cooperatively early enough to make sure it all lines up and then there is a bit of politicking that goes on over the top, and I just think that both of those things are not particularly helpful.[18]

At the same time, both the Victorian and Australian governments need to base their decisions on expert advice when negotiating common goals. Mr Batchelor stated:

> it does require, then, both sides to come to the table. With some projects, like Metro Tunnel, for example—everyone for a long time knew that we had to deliver the Metro Tunnel and that the key to Victoria's train network was unclogging the city loop and making sure that we had more capacity going through the city that was not reliant on infrastructure that was built 50 years ago. It is a bit of a disappointment, then, when the independent experts put a project that is high up on the list for a whole range of reasons and it gets funded but it then does not get the kind of level of support that it probably deserves at both levels of government. Certainly the Commonwealth support for that project probably was not as great as it could or should have been.[19]

Other stakeholders called for more Commonwealth infrastructure investment in specific areas. For example, Mr Broomfield from the Victorian Chamber of Commerce and Industry praised the joint state and federal government investment in developing an mRNA vaccine facility in Victoria but also strongly encouraged the Commonwealth to invest in other 'new, emerging, advanced manufacturing and service provision industries'.[20]

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18 Mr Ryan Batchelor, *Transcript of evidence*, pp. 4–5.

19 Ibid., p. 5.

20 Mr Dylan Broomfield, *Transcript of evidence*, p. 25.

Ms Deborah Fewster, Director of Policy and Advocacy at the Victorian Council of Social Service (VCOSS), the peak body for social and community services in Victoria, added greater investment by the Commonwealth in social housing would be welcome as would a greater focus on social procurement to create jobs for jobseekers facing disadvantage and maximise the return on project investment.[21]

Chief Executive Officer of VCOSS, Ms Emma King, also raised the need for the Commonwealth:

> to invest in aged care, in disability, in family violence, in early childhood services and in a workforce that cannot be replaced because … when we look at future investment we do not just look at that kind of, for want of a better term, bricks-and-mortar investment but we actually look at that investment in our people and in our communities.[22]

She advocated for the Victorian and Australian governments to adopt a wellbeing approach to their budgets similar to New Zealand, Wales and Iceland, which emphasises investing in people, 'because we can have a AAA credit rating, but if we have got over 100,000 people who are homeless, what does that mean at the end of the day?'[23]

The Committee notes that the Victorian Government has received federal funding for projects that are currently being delivered, for instance $2.3 billion provided for upgrades to regional rail across Victoria as part of the Regional Rail Revival Package.[24] However, the evidence received by the Committee indicates Victoria does not receive its fair share of infrastructure funding from the Commonwealth considering its population size and projected population growth. While Victoria is a smaller state, the scale of the gap between population and funding share is disproportionate in the Committee's view. Greater transparency around infrastructure investment decisions would provide more clarity on funding allocations. Also, in order not to have conflicting views on projects between the federal and state governments, the Committee suggests that these governments and their respective infrastructure advisory bodies reach a consensus on priority projects and work more collaboratively on the delivery of projects.

FINDING 7: There is a longstanding and significant gap between Victoria's share of Commonwealth infrastructure funding and its population share as well as a lack of transparency around infrastructure funding decisions.

21 Ms Deborah Fewster, Director, Policy and Advocacy, Victorian Council of Social Service, public hearing, Melbourne, 15 December 2021, *Transcript of evidence*, pp. 31, 32.

22 Ms Emma King, Chief Executive Officer, Victorian Council of Social Service, public hearing, Melbourne, 15 December 2021, *Transcript of evidence*, p. 31.

23 Ibid.

24 Department of Infrastructure, Transport, Regional Development and Communications, *Regional Rail Revival Package*, 2021, <https://investment.infrastructure.gov.au/projects/ProjectDetails.aspx?Project_id=091569-16VIC-PKG> accessed 17 February 2022.

RECOMMENDATION 4: That the Victorian Government drive collaboration between itself, the Australian Government, Infrastructure Victoria and Infrastructure Australia to develop common priorities for infrastructure investment in Victoria based on evidence indicating which projects will deliver the highest net public benefits.

3

3.1.1 Regional Victoria also needs greater Commonwealth infrastructure investment

The COVID-19 pandemic has resulted in a shift towards regional living as more people are able to work remotely. However, regional Victoria's attractiveness to people living in Melbourne has placed pressure on regional infrastructure. As Ms Win Scott, Chair of the Mallee Regional Partnership, stated, population growth in the regions:

> is a very welcome thing, but of course it then puts pressure on us in other ways. For instance, we already have housing shortages, particularly for workers and also social housing. Any increase in population will put additional pressure on housing. We have connectivity issues and people who are moving from metropolitan regions do not expect that because they are used to having excellent connectivity, so that is still an issue and it is obviously one that has a lot of influence from the Commonwealth.[25]

The Mallee Regional Partnership is one of nine partnerships in Victoria that act as a voice for their regions and advise the Victorian Government on regional priorities. Ms Scott told the Committee that population growth in Bendigo and Ballarat is less of a problem due to larger regional centres having better infrastructure than the rest of regional Victoria:

> But in the more rural towns and cities like Echuca, Mildura, Swan Hill, they have got the potential for growth because they have got industries, they have got skills shortages, but they still need support in terms of connectivity—digital connectivity, transport. They are all big issues for those regions—and skills of course because the Commonwealth and state invest in skills.[26]

From the perspective of regional businesses, Mr Broomfield stated:

> regional Victorians have a perception that there is a lack of sufficient infrastructure spending in some areas …
>
> there is a significant need for Commonwealth support to a degree in some of those infrastructure spends, especially on areas of railway, for example, which is a great activator for our exporters in agribusiness, and that is the tracks that are controlled by ARTC [Australian Rail Track Corporation], which do not get the sufficient funding, you could argue, that other states get.[27]

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25 Ms Winifred Scott, Chair, Mallee Regional Partnership, Regional Partnerships, public hearing, Melbourne, 15 December 2021, *Transcript of evidence*, p. 34.

26 Ibid., pp. 35–36.

27 Mr Dylan Broomfield, *Transcript of evidence*, p. 25.

There are also growing concerns about digital connectivity in regional Victoria following natural disasters such as the 2019–20 bushfires, recent storm and flooding events, and the COVID-19 pandemic, which exposed the limitations of the regional telecommunications network. The Australian Government is primarily responsible for telecommunication services across Australia and in its recent submission to the 2021 Regional Telecommunications Independent Review, the Victorian Government called for greater Commonwealth investment in digital connectivity.[28]

The Regional Telecommunications Review is a three-yearly review of the adequacy of telecommunications services in regional, rural and remote Australia for the Australian Government. The 2021 Review has been completed and is expected to be tabled in the Australian Parliament in early 2022.

In its submission, the Victorian Government noted disparities in digital connectivity between regions despite the NBN rollout, and poor coverage and reliability during natural disasters. It argued that digital connectivity is critically important to public safety and the economic and social development of regional communities, since digital technologies have become central to work, education, trade and service use. The COVID-19 pandemic has accelerated regions' reliance on digital connectivity as businesses shift to digitisation, telehealth and online learning become mainstream, and more people migrate to regional Victoria. Through its community engagement, the Victorian Government identified 5,600 locations where locals stated telecommunication services did not meet their needs, specifically the quality and reliability of coverage.[29]

In terms of digital infrastructure, the Victorian Government asked the Australian Government to:

- increase direct subsidies through programs such as the Regional Connectivity program and the Strengthening Telecommunications Against Natural Disasters program to address connectivity gaps and emergency communications resilience, respectively
- establish a broad regional telecommunications policy and investment framework, as well as a policy and program funding approach to address vulnerabilities to the telecommunications network during natural disasters
- invest in regional telecommunications over longer time frames (for example, five years) to provide more certainty to states and regional stakeholders.[30]

Through its Connecting Victoria program, the Victorian Government has invested $550 million in regional digital infrastructure improvements. It called on the Commonwealth to increase its funding commitment by up to $2 billion through direct

28 Victorian Department of Jobs, Precincts and Regions, *Victorian Government submission*, submission to Department of Infrastructure, Transport, Regional Development and Communications, 2021 Regional Telecommunications Independent Review Committee, 2021 Regional telecommunications review, 2021, p. 3.

29 Ibid., p. 6.

30 Ibid., pp. 2–3.

subsidy programs to address connectivity gaps and 'align proportionately' with the Victorian Government's funding commitment.[31]

The Australian Government is expected to provide its response to the Review in early 2022. Investing in regional infrastructure, including digital, transport, housing, education and skills infrastructure, will contribute significantly to the economic development and sustainability of Victoria's regional centres. The Victorian Government should continue to pursue further Commonwealth investment in regional infrastructure.

FINDING 8: Infrastructure needs in regional Victoria are growing as society becomes more reliant on digital connectivity and more people move from metropolitan to regional areas following the COVID-19 pandemic.

RECOMMENDATION 5: That the Victorian Government continue to pursue greater Commonwealth investment in regional infrastructure development, especially projects that will improve digital connectivity, transport networks and skills shortages.

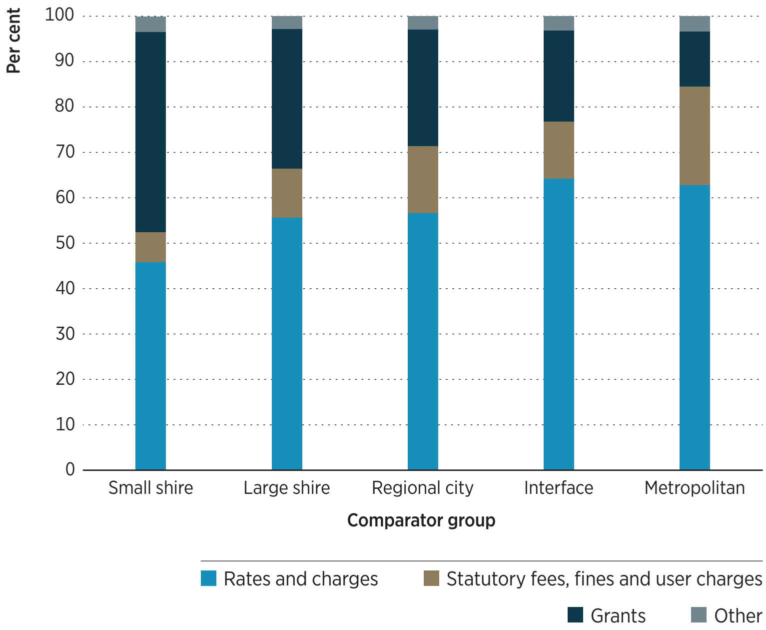
3.2 Local government, especially regional and rural councils, needs more Commonwealth support

Local government in Victoria consists of 79 councils, which are divided into five comparator groups based on their size and location: small shire, large shire, regional city, interface and metropolitan. Regional and rural councils often struggle to deliver services and infrastructure to their communities due to higher costs and lower revenue-raising capabilities.

Councils provide public health, traffic, parking and animal management services to their municipalities and maintain community infrastructure such as roads, bridges, drains, town halls, libraries, recreation facilities, parks and gardens. As shown in Figure 3.3, almost all Victorian council revenue (97%) is gained through rates and charges; statutory fees, fines and user fees; and grants. The levy of municipal rates accounts for most of councils' revenue but grants from the Victorian and Australian governments also make up a considerable portion.

31 Ibid., p. 15.

Figure 3.3 Victorian local government revenue sources by comparator group, 2018–19



Source: Adapted from Municipal Association of Victoria, *Submission 6*, p. 7.

Commonwealth support to local government is primarily through untied Financial Assistance Grants, which in 2018–19 amounted to $646 million and about 35% of Victorian council grant revenue. These grants are divided into general purpose grants ($478 million in 2018–19) and local roads grants ($168 million).[32] According to the Municipal Association of Victoria (MAV), the legislated peak body for local government in Victoria, Financial Assistance Grants are 'a vital component of the financial sustainability of many Victorian councils. This is particularly true for our rural councils.'[33]

The Commonwealth specifies how Financial Assistance Grants are allocated to councils. First, 30% of total allocations are distributed to councils on a per capita basis as a minimum grant requirement, which in Victoria equates to about $21 per capita. The remainder is allocated on a needs basis using the principle of horizontal fiscal equalisation (HFE) to ensure people have similar access to services regardless of which local government area they live in. Sixteen of Victoria's 22 metropolitan councils receive only the minimum grant requirement.[34]

MAV maintained that HFE is critical to support councils because local government areas are very diverse.[35] In Victoria, Financial Assistance Grants are administered by the Victorian Local Government Grants Commission, which considers the impact of economic, geographic and demographic factors on councils' expenditure and capacity to raise revenue when allocating grants on a needs basis. This is critical for rural and

32 Municipal Association of Victoria, *Submission 6*, p. 4; Mr Troy Edwards, Executive Director, Policy and Advocacy, Municipal Association of Victoria, public hearing, Melbourne, 15 December 2021, *Transcript of evidence*, p. 12.

33 Municipal Association of Victoria, *Submission 6*, p. 4.

34 Ibid., p. 9.

35 Ibid., p. 6.

regional councils because they often have higher service delivery costs and smaller and usually more disadvantaged populations from which to raise revenue through rates and fees. Rural and regional councils face greater infrastructure and service delivery costs because of:

- larger road networks
- longer distances to collect and deliver services such as waste management
- their need to operate satellite locations for council operations and services
- smaller economies of scale due to smaller populations
- greater material and labour costs due to their distance from major centres
- more disadvantaged populations that need additional services.[36]

Table 3.1 lists the Financial Assistance Grant allocations provided to each local government comparator group in 2018–19.

Table 3.1 Commonwealth Financial Assistance Grant allocations to Victorian local government by comparator group, 2018–19 ($)

Comparator group	Grant allocation
Small shire	93,276,727
Large shire	156,681,476
Regional city	111,734,527
Interface	117,936,965
Metropolitan	109,048,136
Total	**588,677,831**

Source: Municipal Association of Victoria, *Submission 6*, p. 10.

According to MAV, local government appreciates the automatic and non-competitive process of Financial Assistance Grant allocation. Often, the administrative burden of applying for and reporting on grants, especially smaller programs, can make their value marginal.[37] The Executive Director of Policy and Advocacy at MAV, Mr Troy Edwards, added:

> Financial Assistance Grants from the Commonwealth are a critical source of untied income and in many ways the only source of untied income that councils have other than rates revenue, which does allow them to ensure that local infrastructure and services can be delivered to meet local needs and aspirations.[38]

36 Ibid., p. 8.

37 Ibid., p. 10.

38 Mr Troy Edwards, *Transcript of evidence*, p. 12.

In addition to Financial Assistance Grants, the Commonwealth also provides specific-purpose grants to Victorian councils, which amounted to $464 million in 2018–19. The Commonwealth provides these grants for specific services and activities, such as aged and disability services, family and community services, and recreation and culture.[39] Table 3.2 presents the types and amounts of specific-purpose grants provided to Victorian local government by comparator group in 2018–19.

Table 3.2 **Specific-purpose Commonwealth grants to Victorian local government by comparator group, 2018–19 ($ million)**

Function	Small shire	Large shire	Regional city	Interface	Metropolitan	Total[(a)]
Governance	20.002	0.254	1.597	0.296	11.507	**33.656**
Family and community services	1.986	5.623	13.146	16.588	36.077	**73.420**
Aged and disability services	9.260	16.531	37.169	37.962	117.283	**218.204**
Recreation and culture	4.260	5.190	13.140	8.904	11.826	**43.319**
Waste management	..	..	..	..	0.017	**0.017**
Traffic and street management	1.293	1.148	0.139	2.079	0.199	**4.857**
Environment	4.485	0.489	1.456	..	0.190	**6.622**
Business and economic services	0.162	3.543	0.703	0.250	0.604	**5.263**
Local roads and bridges	15.702	31.987	11.281	8.447	7.819	**75.237**
Main roads	1.261	0.048	1.497	..	..	**2.806**
Other	..	..	..	..	0.852	**0.852**
Total[(a)]	**58.410**	**64.813**	**80.128**	**74.525**	**186.377**	**464.254**

Note: .. = nil

a. Figures may not sum to totals due to rounding.

Source: Adapted from Municipal Association of Victoria, *Submission 6*, pp. 4–5.

Victorian councils are responsible for 87% of the state's road network so they appreciate the infrastructure grants provided by the Commonwealth through the Roads to Recovery and Local Roads and Community Infrastructure programs.[40] The cost of managing and maintaining local road networks and associated assets often exceeds the level of rate revenue councils can raise due to the Victorian Government-imposed rate cap and the capacity of communities to pay. Many councils, especially rural and regional councils, struggle to deliver on road priorities and rely on grants from the Victorian and Australian governments.

39 Municipal Association of Victoria, *Submission 6*, p. 5.

40 Ibid., p. 11.

In its 2018–19 audit of local government, the Victorian Auditor-General's Office noted Victorian councils generate $11.6 billion in revenue while managing an asset portfolio of $103.3 billion.[41] The Victorian Auditor General's Office also found the average capital replacement ratio, which compares infrastructure spending rates with depreciation, for regional city, large shire and small shire councils was less than 1.5 in 2018–19, indicating a medium financial sustainability risk.[42] MAV called for increased funding for infrastructure through untied and specific-purpose grants to meet this challenge and noted greater investment in infrastructure creates 'safety and amenity benefits, local stimulus, and whole of economy benefits through more efficient movement of freight and labour.'[43]

In 2014–15, the Commonwealth imposed a three-year indexation freeze on Financial Assistance Grants, which MAV states reduced grant levels by 12.5%, or about $40 million, from what they would have been once indexation resumed in 2017–18.[44] A 2018 parliamentary inquiry into the sustainability and operational challenges of Victoria's rural and regional councils recommended the Victorian Government seek an increase to the Financial Assistance Grants pool to compensate for the indexation freeze.[45]

MAV noted the Australian Government has not addressed this shortfall and Mr Edwards instead asked for the Commonwealth to raise the level of Financial Assistance Grants to the same percentage of total Commonwealth revenue it stood at before the indexation freeze:

> The local government sector nationally has a view that the challenge for all parties at the Commonwealth level is to actually increase the pool of funds and restore it to the 1% of total Commonwealth revenue, which is where it was pegged at when the Financial Assistance Grants were created. And that has kind of been eroded over the years …[46]

Outside of Financial Assistance Grants, MAV also called for more Commonwealth support to assist councils with disaster preparedness, climate change resilience and early childhood education and care services. For example, it supported a dedicated Commonwealth funding stream for disaster preparedness that would assist councils to increase their future resilience.[47]

Most Commonwealth disaster support to local government is provided through Disaster Recovery Funding Arrangements, which are joint cost-sharing arrangements between the state and Australian governments. In its submission to the 2020 Royal Commission into National Natural Disaster Arrangements, MAV proposed improvements such as

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41 Victorian Auditor General's Office, *Results of 2018–19 audits: local government*, Victorian Government Printer, Melbourne, November 2019, pp. 30, 34.

42 Ibid., p. 34.

43 Municipal Association of Victoria, *Submission 6*, p. 11.

44 Ibid., p. 10; Mr Troy Edwards, *Transcript of evidence*, p. 6.

45 Parliament of Victoria, Environment, Natural Resources and Regional Development Committee, *Inquiry into the sustainability and operational challenges of Victoria's rural and regional councils*, March 2018, p. 13.

46 Mr Troy Edwards, *Transcript of evidence*, p. 14.

47 Municipal Association of Victoria, *Submission 6*, p. 13.

greater flexibility for councils to improve the resilience of infrastructure rather than replacing like-for-like, funding to repair and replace a wider range of community facilities, improving councils' ability to recover costs, and reducing the burden of producing pre- and post-disaster evidence (such as asset condition photographs of roads).[48] Mr Edwards observed that local government in Queensland finds it easier and quicker to access funding than Victorian councils due to there being fewer bureaucratic steps involved.[49]

Victorian councils also struggle with short-term Commonwealth funding arrangements for kindergarten programs under the Universal Access National Partnership, an agreement between the Australian and state governments to provide preschool to all children in the year before school. As explained by Mr Edwards:

> the biggest improvement I think would be longer time windows on some of those grant programs, to provide better certainty for planning. Often being caught in one-, two-, three-year-type cycles can be quite hard when it comes to councils planning, for example, their capital program. When money is tight you perhaps need longer time windows to ensure you can build, say, new early years facilities for kindergarten programs and day care and make sure that those time windows are longer to give us a bit more stability around just being able to deliver the service.
>
> We are probably seeing that the shorter time frames are adding to some workforce pressures for the sector as well, in terms of ensuring we can plan to access, for example, early years workers to work in these facilities that we are building as well.[50]

In addition, local government faces a critical risk from climate change and it needs financial support from the Commonwealth as well as information, expert advice and best practice guidelines on climate action plans to address it.[51] MAV has been advocating for greater Commonwealth involvement in setting climate change policies and measures such as tax incentives, and other reforms to 'really drive climate-positive behaviours.'[52]

While there are arguments against rate capping, the 2018 parliamentary inquiry found continual large increases to rates are not sustainable for ratepayers. It recognised that Victorian councils experience financial pressures but did not consider rate increases an answer because of 'a number of inequalities and difficulties with the rating system.'[53] Because of the rate cap, local government relies heavily on grants to deliver services and infrastructure. The value of Commonwealth Financial Assistance Grants has fallen following the three-year indexation freeze from 2014–15, and the Victorian Government should continue to appeal for increased Commonwealth support to compensate for this.

48 Ibid., pp. 12–13.

49 Mr Troy Edwards, *Transcript of evidence*, p. 13.

50 Ibid., p. 14.

51 Municipal Association of Victoria, *Submission 6*, p. 14.

52 Mr Troy Edwards, *Transcript of evidence*, p. 13.

53 Parliament of Victoria, Environment, Natural Resources and Regional Development Committee, *Inquiry into the sustainability and operational challenges of Victoria's rural and regional councils*, pp. 94, 117.

FINDING 9: Commonwealth grants are critical for the financial sustainability of Victorian councils, especially rural and regional councils, which have greater expenditure requirements and less capacity to raise revenue than metropolitan councils.

RECOMMENDATION 6: That the Victorian Government advocate that a greater proportion of Commonwealth revenue be allocated to Financial Assistance Grants for local government.

3.3 More Commonwealth support is needed to address impacts of COVID-19

Stakeholders raised the need for the Commonwealth to provide more support for Victoria as it recovers from the COVID-19 pandemic. Victoria experienced a longer and more severe economic contraction than all the other states due to the extended lockdowns and trade restrictions imposed to reduce the spread of COVID-19.[54] Despite the lockdowns and restrictions, Victorian DTF Secretary, Mr Martine, was 'very optimistic about the strength in the Victorian economy and recovery.'[55]

However, Dr Angela Jackson, Lead Economist at Equity Economics, stated that the impact of COVID-19 on Victoria goes beyond the economic effects and social distress of lockdowns. She said:

> if we think about the long-term mental health impacts for Victorians, the long-term impacts on our education, higher rates of domestic violence and the likely much higher healthcare costs as well—and we certainly saw, during the reopening, demand in the public system just going to levels previously not seen—there is a need I think for the Commonwealth to really take a look at 'Well, what are the needs going to be in Victoria in this recovery period?'
>
> … there is obviously going to be a greater demand for a lot of services as a result, but also if not addressed, on productivity—we know that poor mental health is associated with much lower levels of productivity. We know that if we do not address the education shortfalls, particularly for disadvantaged kids, that is going to impact their transition into employment and further education. So I think help, particularly with those states most impacted, with strengthening those social services is also quite critical and timely. I note Victoria has obviously invested more. New South Wales has also indicated greater investments. But whether there is a fiscal power there to really put the money in where it is needed and when it is needed, I think there is a role there for Commonwealth support.[56]

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54 The McKell Institute Victoria, *Bridge over troubled water: the role of Victoria's infrastructure pipeline during the COVID-19 recession*, The McKell Institute, Melbourne, 2021, p. 6.

55 Mr David Martine, *Transcript of evidence*, p. 20.

56 Dr Angela Jackson, Lead Economist, Equity Economics, public hearing, Melbourne, 10 December 2021, *Transcript of evidence*, pp. 15–16.

Ms King from VCOSS reiterated the increased demand on services:

> In terms of the demand for frontline services, it has increased exponentially, because we have people who were already on JobSeeker [unemployment benefit], which has now been cut back to its pre-existing rate, fundamentally, and we also have a whole new cohort of people that require the assistance of frontline community service organisations who did not need that assistance before and perhaps never thought that they would actually need it as well. So the impact of that is really profound … and we are very much seeing our frontline organisations—those that provide assistance around housing, around material aid et cetera—having demand like they have never seen before. It truly is unprecedented.[57]

Both the Australian and Victorian governments provided significant amounts of financial assistance to support households and businesses and maintain economic activity during the pandemic. While VCOSS approves of this spending because for a short time it alleviated poverty and disadvantage, the spending has:

> severely impacted the state's financial position and outlook. Victoria's midyear budget update notes that risks to Victoria's economic outlook remain greater than normal and they continue to be dominated by the COVID-19 pandemic and potential changes to global and domestic economic policy responses. So to ensure an equitable economic recovery, we need to keep investing in inclusive social recovery.
>
> It is crucial that the Commonwealth has our back and plays its part in helping us to build back better.[58]

She called for a permanent increase to JobSeeker payments and longer Commonwealth funding contracts of about seven years for social service organisations providing frontline services.[59]

There also remains an ongoing economic risk due to the emergence of new COVID-19 variants and the persistence of international travel restrictions, which affect the education and tourism sectors.[60] Mr Broomfield from the Victorian Chamber of Commerce and Industry stated:

> before we even start looking at funding one of the key things we need is immigration back into Victoria; that is huge. One of the other areas that they [the Australian Government] could just start funding and commit to would be international students. We have the biggest tertiary education sector in the country, and they have felt very hard the impacts of students not coming back. So that would be one area straightaway, and it is not really a high cost either. Outside of that, the other things that would be really useful in order to take advantage of what is out there at the moment would be continuing the asset reduction write-off that the Commonwealth has. That has been really useful, again, for regional Victorians. You know, the capacity to go out and spend

57 Ms Emma King, *Transcript of evidence*, pp. 30–31.

58 Ibid., p. 30.

59 Ibid., p. 32.

60 The McKell Institute Victoria, *Bridge over troubled water*, p. 5.

> on some capital for their business—that is great. That is something that they should push and go ahead with again.[61]

He added that businesses are struggling to find staff and would benefit from more training opportunities to address skills shortages and more access to affordable housing in regional areas to enable workers to live in areas with labour shortages.[62]

Ms Scott from the Mallee Regional Partnership noted one of the positives to come from the pandemic was instances of better collaboration between the states and the Commonwealth, such as the appointment of the Cross Border Commissioner, who works with border residents, businesses and community organisations to improve access to services and make it easier to do business across the borders.[63]

Dr Jackson also supported greater cooperation between the Commonwealth and the states to create a more equitable and more productive economy. She suggested the COVID-19 pandemic may provide the impetus for improved collaboration, stating:

> potentially coming out of COVID you are going to see, and you have certainly seen, premiers more visible on our TV screens than ever before, taking real leadership positions. Potentially if they come together around some of these issues and there is common ground, there is capacity for these types of agreements like there has not been before, because I think the political carry of most state premiers at the moment is relatively high, let us say, coming out of the pandemic. I think state populations have been pretty impressed by the quality of leadership across the board, and perhaps it is a time where they are in a stronger position to be arguing for some of this overall rebalancing of the system.[64]

The Committee notes that the Australian Government provided approximately $28 billion to Victorian workers eligible for the JobKeeper Payment between March 2020 and March 2021.[65] However, the ongoing social and economic burdens of the COVID-19 pandemic on Victoria are significant and will place continuing pressure on the Victorian budget and the wellbeing of Victorians for many years to come. The Victorian Government should continue to actively seek additional Commonwealth support and collaboration to assist in the recovery from the many negative impacts of the pandemic which have disproportionally impacted Victorians.

FINDING 10: The COVID-19 pandemic has placed significant and continuing pressures on the Victorian economy, increased demand for frontline services, as well as negatively impacted the mental health and wellbeing of many Victorians.

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61 Mr Dylan Broomfield, *Transcript of evidence*, p. 25.

62 Ibid., p. 27.

63 Ms Winifred Scott, *Transcript of evidence*, p. 34.

64 Dr Angela Jackson, *Transcript of evidence*, p. 17.

65 The Australian Treasury, *Insights from the first six months of JobKeeper*, Commonwealth of Australia, Canberra, October 2021, p. 20; Dr Steven Kennedy, Secretary to the Treasury, 'Opening statement - Economics Legislation Committee', speech delivered at Parliament House, Canberra, 24 March 2021.

RECOMMENDATION 7: That the Victorian Government continue to advocate that the Australian Government provide additional support to address the significant and ongoing negative impacts of the COVID-19 pandemic on Victoria's businesses, social service organisations and vulnerable populations as well as on the wellbeing of all Victorians.

4 Concluding remarks

The Commonwealth's new equalisation arrangements for distributing GST revenue to the states and territories are damaging to Victoria and will create inequity between Australia's jurisdictions. Once the transitional no-worse-off guarantee ends in 2026–27, Victoria is likely to lose billions of dollars in GST revenue over the following years. Without this revenue, future Victorian governments will have to adapt by reducing the quantity or quality of vital public services such as health and education, imposing higher or new state taxes, and/or incurring more debt. This will have a significant negative impact on the quality of life of all Victorians.

The impacts of the Commonwealth's GST distribution reforms, which begin in 2021–22, extend beyond Victoria to most other states and territories. Modelling by various state treasury departments has shown that under multiple scenarios, all states except Western Australia are set to lose GST revenue when the no-worse-off guarantee expires. The new equalisation arrangements benefit Western Australia by increasing its GST relativity and GST revenue share at the expense of the other states. This is despite Western Australia recording budget surpluses and being the nation's fiscally strongest state for the foreseeable future.

As a result, these reforms will entrench inequity between the states and territories as Western Australia's increased revenue will enable it to provide better public services and reduce state taxes while other states and territories will have to do the opposite to deal with a lower GST share than they would have had otherwise.

A further criticism of the Commonwealth's GST distribution reforms is that the cost of the no-worse-off guarantee payments will greatly exceed the Commonwealth's original projected costs. The billions of dollars required to meet the guarantee, which ensures states and territories receive GST revenue based on the better of the old or new system until 2026–27, could have been spent elsewhere such as on measures to boost productivity or to support the states and territories to recover from the impacts of the COVID-19 pandemic.

The Committee favours a return to the former equalisation arrangements for distributing GST revenue. If the Victorian and other adversely affected state and territory governments are unsuccessful at convincing the Australian Government to revert to the previous system of GST distribution, they should demand the no-worse-off guarantee continue beyond 2026–27 until the inequities created by the new system are resolved.

This Inquiry also uncovered issues with Victoria's share of Commonwealth infrastructure investment, which is regularly and significantly below Victoria's population share. This gap, which is not replicated for other states, also highlights the lack of transparency around investment decisions and a lack of collaboration between the state and federal governments in infrastructure planning. Improvement in collaboration between the state and federal governments, may assist the Victorian Government to deliver projects on time and on budget. The Committee also found regional and rural Victorian councils need greater financial assistance from the Commonwealth.

Victoria has been hard hit by the COVID-19 pandemic. Protracted lockdowns have negatively impacted the economy, businesses and the physical and mental wellbeing of many Victorians, especially vulnerable populations. Despite Victorian workers receiving $28 billion from the Australian Government's JobKeeper Payment, the social and economic ramifications of the pandemic will be felt by Victoria for many years to come. the Australian Government should provide further support and collaboration to help Victoria respond to and recover from the impacts of the COVID-19 pandemic.

Adopted by the Legislative Assembly Economy and Infrastructure Committee
Melbourne
25 February 2022

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Appendix A
About the Inquiry

A.1 Submissions

Submission number	Individual or organisation	Date received
1	Mr Saul Eslake	21 September 2021
2	Premier of Tasmania	20 October 2021
3	Commonwealth Grants Commission	22 October 2021
4	Victorian Department of Treasury and Finance	28 October 2021
5	The McKell Institute Victoria	28 October 2021
6	Municipal Association of Victoria	28 October 2021
7	Western Australian Department of Treasury	28 October 2021
8	ACT Government	1 November 2021
9	The Samuel Griffith Society	3 November 2021
10	Government of South Australia	11 November 2021

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A.2 Public hearings

Friday 10 December 2021

Melbourne

Name	Title	Organisation
Mr Mike Callaghan	Chairperson	Commonwealth Grants Commission
Mr Jonathan Rollings	Secretary	Commonwealth Grants Commission
Mr Saul Eslake	Economist and Principal	Corinna Economic Advisory
Dr Angela Jackson	Lead Economist	Equity Economics
Mr Chris Murphy	Economist and Visiting Fellow	Australian National University

Wednesday 15 December 2021

Melbourne

Name	Title	Organisation
Mr Ryan Batchelor	Executive Director	The McKell Institute Victoria
Mr Xavier Boffa	Executive Director	The Samuel Griffith Society
Mr Thomas Rowe	Research Associate	The Samuel Griffith Society
Mr Troy Edwards	Executive Director, Policy and Advocacy	Municipal Association of Victoria
Mr David Martine	Secretary	Victorian Department of Treasury and Finance
Mr Chris Barrett	Deputy Secretary, Economic Division	Victorian Department of Treasury and Finance
Mr Andrew Witchard	Executive Director, Revenue Group	Victorian Department of Treasury and Finance
Mr Dylan Broomfield	General Manager, Policy and Advocacy	Victorian Chamber of Commerce and Industry
Ms Emma King	Chief Executive Officer	Victorian Council of Social Service
Ms Deborah Fewster	Director, Policy and Advocacy	Victorian Council of Social Service
Ms Winifred (Win) Scott	Chair, Mallee Regional Partnership	Regional Partnerships

Glossary

Commonwealth Own Purpose Expenditure (COPE)	Payments the Commonwealth provides to state and territory agencies to deliver services on behalf of the Commonwealth, for example, payments to hospitals for Pharmaceutical Benefit Scheme and residential aged care subsidies.
Financial Assistance Grants	Untied grants which are the Commonwealth's primary support to local councils. Financial Assistance Grants are divided into general purpose grants and local roads grants.
Former equalisation arrangements	The Australian Government's arrangements for horizontal fiscal equalisation prior to the new system introduced by the *Treasury Laws Amendment (Making Sure Every State and Territory Gets Their Fair Share of GST) Act 2018* (Cth).
GST relativity	A per capita weight that determines a state or territory's GST revenue share. It is an average of the state or territory's calculated relativities for the last three completed financial years to avoid the influence of a single year on the upcoming year's calculation.
Horizontal fiscal equalisation (HFE)	HFE is designed to equalise state and territories' revenue raising abilities and expense burdens so they can provide similar levels of services and infrastructure. It aims to ensure Australians have access to similar levels of government services irrespective of the state or territory they choose to live in.
Infrastructure	Assets that provide, or enable the provision of, services that are essential to the operation of society, such as electricity, water, schools, roads and hospitals.
Intergovernmental agreements (IGAs)	Agreements made by the Commonwealth and state governments to outline their commitment to work together to achieve certain goals or objectives.
National GST pool	The amount of GST collected by the Commonwealth.
New equalisation arrangements	The arrangements for horizontal fiscal equalisation introduced by the *Treasury Laws Amendment (Making Sure Every State and Territory Gets Their Fair Share of GST) Act 2018* (Cth) which came into effect in 2021–22.
No-worse-off guarantee	A guarantee provided in the *Treasury Laws Amendment (Making Sure Every State and Territory Gets Their Fair Share of GST) Act 2018* (Cth) to ensure no state or territory is disadvantaged from the shift to the new system by ensuring the GST revenue it receives is based on the better of the old or new system. It is legislated until 2026–27 when the transition period ends.
No-worse-off relativity	The relativity that the Commonwealth Grants Commission will use during the transition period to determine if a state is worse off under the new system.
Relative fiscal capacity	A measure used to inform the GST revenue a state needs in order to provide the national average standard of services and infrastructure for its population assuming it makes the average effort to raise revenue and operates at the average level of efficiency.
Relativity floor	The minimum GST relativity.
Tied grants	Grants for specific purposes such as delivering infrastructure or health, education and community services. Usually the Commonwealth sets conditions on how the states and territories can spend this money.
Untied grants	Grants that have no conditions and the Commonwealth has no direct say on how these funds are used. Untied grants are also called general purpose grants.
Vertical fiscal imbalance	An imbalanced caused by the Commonwealth having greater revenue raising powers than the states and territories, while it is the states and territories, and to a lesser extent councils, that are responsible for the delivery of most services.

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