

# TRANSCRIPT

## LEGISLATIVE ASSEMBLY ECONOMY AND INFRASTRUCTURE COMMITTEE

### **Inquiry into Commonwealth support for Victoria**

Melbourne—Friday, 10 December 2021

#### **MEMBERS**

Mr John Eren—Chair

Mr Gary Blackwood—Deputy Chair

Ms Juliana Addison

Ms Christine Couzens

Ms Steph Ryan

Ms Kat Theophanous

Mr Nick Wakeling

#### **WITNESS** (*via videoconference*)

Mr Chris Murphy, Economist and Visiting Fellow, Australian National University.

**The CHAIR:** Welcome, Chris, to the hearings of the Legislative Assembly Economy and Infrastructure Committee's Inquiry into Commonwealth support for Victoria. All mobile telephones should now be turned to silent.

All evidence taken by this Committee is protected by parliamentary privilege. Therefore you are protected against any action for what you say here today, but if you repeat the same things outside this hearing, including on social media, those comments may not be protected by this privilege.

All evidence given today is being recorded by Hansard. You will be provided with a proof version of the transcript for you to check. Transcripts will ultimately be made public and posted on the Committee's website. I remind members and witnesses to mute their microphones when not speaking, to minimise interference.

I now invite you to make a brief opening statement. Thank you very much for being with us.

### **Visual presentation.**

**Mr MURPHY:** Thank you for the opportunity to speak with you today about alternative systems of fiscal equalisation and how they would affect the Victorian budget, the budgets of other states and also the national economy. There are four systems of fiscal equalisation that I would like to speak to you about.

So if you would just move to the next slide, please, the first system is the original system, or old system, of full equalisation, which we are now moving away from. The next system is the grants system, which the Productivity Commission recommended in its 2018 report. The third system is one I have called the 'WA relief' system, which is the new government system which is being gradually introduced. The fourth system is the sort of system that you would have using principles from public economics—the economists' system, if you like—which I have called the 'efficient' system. Then finally, I am going to compare the systems for their effects on state finances and the national economy, with a particular focus on Victoria.

So moving on to the next slide, as you would know, like many federations Australia has a system of fiscal equalisation where the more fiscally advantaged or donor states make transfers to the more fiscally disadvantaged or recipient states. For a long time we have had a system of equalisation which is relatively unusual in the world, where the fiscal inequalities are fully equalised, and since 2000 the system has been based around the GST. So in the first step each state is allocated a share of GST revenue based on its share of the national population, and in the second step that initial allocation is adjusted for equalisation transfers based on which states are assessed to be fiscally advantaged or disadvantaged by the Grants Commission. The Grants Commission has most recently estimated that in 2021–22 there would be \$67 billion to be distributed, although actually it would be more than that with the economy's bounce back post COVID.

Moving on to the next slide, the Productivity Commission recommended what it called equalisation to the average of all states, although it is more generally known in the literature as a grants system. So under a grants system donor states no longer have to pay into the pool, but recipient states still receive their payments, and those payments are funded out of the pool itself on a per capita basis from all states. So we will see how all that works out in a minute. The PC is still relevant in this process, I think, because by the end of 2026 they have to report back to the Government about how the Government's new system is working.

The next slide is about the system that the Government has introduced. Now, the background to this is that the fiscally strongest state in the Grants Commission's assessment is always WA, New South Wales or Victoria, but under the new system only New South Wales or Victoria can be declared as the fiscally strongest state. So the new system has a special carve-out for Western Australia in that it can no longer be declared as the fiscally strongest state, so I think it is more aptly described as the WA relief system. It will be fully phased in from 2027–28 when the no-state-worse-off guarantee expires. As part of the new system there is also a floor of 75 cents in the dollar that WA would receive, but this floor will become irrelevant because under the WA relief system it will actually receive more than that.

Moving on to the next slide, this is what I have called the efficient system, under which each state is able to offer a given type of labour the same dollar value of government services net of taxes, or net fiscal benefit. So this is an efficient system, and the idea of this kind of system is that labour decides in which state it will live based on economic opportunities, not based on states offering different net fiscal benefits. How that works and will impact us I will explain a bit more in a moment.

I will move on to the next slide. This slide—and I will not try and explain all the details—basically shows how the Grants Commission works out its transfers between states. In its most recent assessment, for 2021–22—you can see down the bottom the transfers between the states—its system says, for example, that nearly \$4.7 billion should be transferred from WA to less fiscally advantaged states, and that mainly arises because of the very big fiscal advantage WA has from mining revenues, which you can see in the top row there: a fiscal advantage of \$6.4 billion. New South Wales and Victoria are also assessed to have some fiscal advantage, mainly from the sort of revenue they get from land tax and stamp duties because of the high property values. You can see that in the orange there to the left.

Moving on to the next slide, this shows what the GST grants would have been had the old system continued to operate in 2021–22. In the first column we take the GST pool of \$67 billion and we share it up between the states based on their shares of the national population for their per capita-based grants. The second column takes those calculations you saw in the previous slide for the transfers between states, including the \$4.7 billion taken off Western Australia, and adjusts the initial per capita grants based on those equalisation transfers. When you add those two together it gives you the third column, which shows the grants that each state actually receives. We can calculate those grants as a ratio to what they would have received based on a per capita basis, and that gives you the so-called GST relativities in the final column. If the old system had continued to operate, for example, WA's GST relativity would have been around 0.33 and Victoria's would have been about 0.93, but 2021–22 is the first year of transition to the new system so the relativities are somewhat different from that.

Moving on to the next slide, it just shows you the same information on a per capita basis. So instead of each state getting a per capita grant of \$2,608 per head of population, it gets adjusted for the equalisation transfers to give you the figures you see there in the third column in terms of per capita grants.

The next slide just shows the Productivity Commission's grants scheme. The Grants Commission would do exactly the same calculations as under the old system except the donor states of New South Wales, Victoria and WA no longer have to pay into the pool, so their transfers are set to zero. You can see that highlighted in blue. That is the only difference initially. However, then that means the recipients payments are no longer funded so they would be funded from the pool on a per capita basis, so you see the cost of the grant in the third column and that gives you the final transfers in the fourth column.

Moving on to the next slide, that shows you what the relativities would have looked like if the Productivity Commission's recommendations had been accepted. The three donor states—New South Wales, Victoria and WA—for example, would all be sitting on a relativity of 0.9.

The next slide is the system the Government has actually introduced. It is only gradually phased in. This shows what would have happened in 2021–22 had the new system already been fully phased in. Again, all the same calculations are done by the Grants Commission. The difference is that WA cannot be assessed as being any more fiscally advantaged than New South Wales or Victoria. In this case it would be Victoria. So the payment by WA is drastically reduced: it would only be \$462 million. That creates a shortfall of \$4.202 billion, and that is made up in the third column by taking money off all states on a per capita basis to fund the cut in the WA payment into the pool. That gives you the numbers in the final column. So this slide makes the point very clear that the new system is basically a special deal for WA.

Moving on to the next slide, you see what the relativities would look like had the new system been fully phased in. Victoria and WA would be sitting on relativities of 0.87. All states other than WA would receive a lower grant than under the old system, so it is WA that gets all of the benefit of this new system.

Moving on to the next slide, we are now moving on to the efficient system. One of the ingredients of this is stepping back and figuring out what is the capacity of each state to raise revenue from its residents. Under an efficient system you would not assess that based on your revenue. They are actually raising the bar, because that can be influenced by lots of things, not just the population hand that each state has been dealt, if you like. So this exercise looks at each state, its demographic profile according to distribution by age, educational attainment and Indigeneity and predicts what its income per head would be just based on its demographic profile. You see the ACT has the highest predicted income per head of nearly \$40,000 a year because it has a relatively highly educated population. The Northern Territory is the lowest at about \$30,000 because of its high Indigenous population. So this is an alternative way of doing an assessment for things like payroll tax.

Moving on to the next slide, this shows what an efficient equalisation system would look like. Much of it is the same as full equalisation, so for things like mining, land tax and stamp duty it is the same. But we use this population profile information for those five rows of revenue that you see towards the top of the table. An efficient system would not equalise the differences in costs between states. So you can see it wipes out various forms of equalisation on the expenses side.

Then the next slide. Now we are getting on to the point of being able to do a comparison between all of the systems. Probably of particular interest, is the equalisation transfer for Victoria highlighted in orange under each of the four systems. Under the old system Victoria would be paying in \$1.168 billion into the pool. Under the grants system recommended by the PC that would go up to \$1.712 billion. Once the new system is fully phased in, it goes up further to \$2.266 billion, but on my calculations under an efficient system that an economist might recommend it would actually go down to \$416 million. In terms of WA, under the old system, it would be paying in \$4.664 billion. Under an efficient system it would be paying in virtually the same amount, \$4.724 billion because it is efficient to equalise for mining royalties, but under either the PC system or the Government system it would be paying in less than \$1 billion. So it is a very big difference in how WA is treated.

Moving on to the next slide, we can also look at the same information in terms of relativities. You can see that WA gets a relativity of around 0.32 or 0.33 under an efficient system or the old system, but under the new system ultimately its relativity is going to go up to about 0.87. Victoria, on the other hand, would have got a relativity of 0.93 under the old system. I think under an efficient system that would actually go up to 0.98, so close to one, but under the WA relief system that is being phased in it will go down further to 0.87 ultimately.

Moving on to the next slide, if we look at this from a national point of view, the new system is going to result in a less efficient allocation of labour between states. People are going to be artificially attracted to moving to WA because of its fiscal advantage, which is not being equalised. WA would be able to, for example, offer very low payroll tax rates if it chose to, and that inefficient allocation of labour means there is a drop in consumer welfare, which you see there, of \$131 million annually. The PC system has a similar effect, whereas if we make the system more efficient, as I am suggesting, the contribution to economic welfare would actually go up—it would be plus \$104 million.

Moving on to the next slide, this shows the impacts on the population of each state that are modelled in the long run under each system, compared with the old full equalisation system. So this is predicting that ultimately WA will gain about 4 per cent in population under the new system because of the very strong fiscal position it will have, enabling it, for example, to offer very low payroll tax rates. If we move to a more efficient system, the Northern Territory would actually receive less. It would no longer get compensated for its cost disadvantages, for example, and that would lead to some loss of population to the Northern Territory.

Moving on to the next slide, which is my conclusions—hopefully I have kept to time—basically I have four conclusions. The new system, when it is fully phased in by 2027–28, based on the assessment of fiscal advantage and disadvantage for 2021–22 done by the Grants Commission, will leave Western Australia with \$3.8 billion more than it would receive under either an efficient system or the old full equalisation system. As I said, this would attract economic activities to Western Australia that would be more productively undertaken in other states. National economic welfare would be lower than under the existing system or under an efficient system. Under an efficient system, which would equalise most but not all sources of fiscal advantage or disadvantage, New South Wales and Victoria would both have fiscal relativities of near one. The fiscal relativity of WA would be similar to under the old full equalisation system, around that 0.32 or 0.33 mark, which would then pay for the fiscal disadvantages of places like the Northern Territory, Tasmania and South Australia. The worst option, though, would be to entirely eliminate fiscal equalisation, as that would lead to shifts in economic activity between states that are inspired by net fiscal benefits rather than by economic opportunities.

I think I have gone slightly over time, so thank you for your patience with that, and thank you for the opportunity to present to you. I look forward to your questions.

**The CHAIR:** Thank you, Chris. I think Nick has to leave us pretty soon, so I will go to Nick straightaway for the first question.

**Mr WAKELING:** I appreciate that, Chair. Thank you. Chris, thank you very much for your presentation. I was just wanting to come back to the issues you raised around payroll tax and employment. How valid is the theory that states have a reduced incentive to grow their economy because they will reduce their share of GST revenue?

**Mr MURPHY:** Well, in terms of the theory, if they are receiving less GST revenue, than would be efficient—that is less than in my ‘efficient’ scenario. That means that they are in a worse fiscal position than they should be, which they will need to deal with in some way, either offering a lower level of government services than is available elsewhere or charging higher taxes, and that is going to influence the location of businesses and households. So it is almost beyond the control of the state, right? The state economy is going to be a bit smaller than it would otherwise be, as you saw in the charts that I presented.

**Mr WAKELING:** Thanks very much; and thank you, Chair.

**The CHAIR:** No worries. Thank you. Next question. Chris Couzens.

**Ms COUZENS:** Thank you for your time today. We appreciate your contribution. Given the economic impacts for women, particularly during COVID, how would lower GST revenue be likely to affect the economic and social wellbeing of Victorian women?

**Mr MURPHY:** As I was saying before, it would put Victoria in a worse fiscal position than would be efficient. So I guess there are two ways you can look at that. One way is in terms of it creating inequities between states, which I guess is what you are sort of driving at—that 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 under an efficient system. I think that is sort of true in the short run. I think 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 I think you are right—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 a position to offer the services that it should be able to offer. So yes, I would be emphasising the longer term efficiency aspects. In the shorter term, though, I agree with you that the equity aspects also come into it. But ultimately people will respond to that. People will move.

**The CHAIR:** Thank you. Gary, do you have a question?

**Mr BLACKWOOD:** Thanks, Chair; and thanks, Chris, for all the work you have put into your presentation. In terms of Western Australia’s ongoing argument about the volatility of iron ore prices, how valid do you think this argument really is?

**Mr MURPHY:** Well, 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. With the new system, though, 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. Perhaps I should leave it at that. I could put it more strongly, but perhaps I should leave it at that. It is an asymmetric system—WA cannot lose under this system. It is a special deal for WA.

**Mr BLACKWOOD:** Yes, spot on. Thank you, mate.

**The CHAIR:** Thanks, Chris. Juliana, do you have a question?

**Ms ADDISON:** Lots of questions. My arts degree is not helping me as much as I hoped it would in these discussions. Chris, thank you so much for the detail that you are providing. It is really presenting a picture for us about equity amongst the states. I am really learning a lot today, so thank you. I was wondering if you could

share any views on how you think the COVID-19 pandemic will affect the calculated fiscal capacities of states and territories in the future. Obviously a one-in-100-year event changes everything.

**Mr MURPHY:** Right. I do macro-economic modelling as well, so I do follow how COVID affects the economy. In fact I have got a paper I am just finishing off on that subject, which I have presented at various places. I think it is too early to say how it might affect individual states longer term. Obviously that will have short-term effects, which will feed into the equalisation process. But I think the indications so far are that we are on track to more or less bounce back to normal. So I think down the track hopefully it will not have too many effects. I think there are a couple of kinds of effects that it could have to some degree. I mean, in the US, as you probably know, there has been talk of this great resignation, with some people deciding they do not want to participate in the workforce in the same way that they did. In the Australian data that is not coming out strongly yet, so hopefully that will not happen. The other thing you would be concerned about is some businesses, especially small businesses, being weakened by the experience and potentially never getting back to the situation they were in. So there could be a problem of sort of stranded capital—capital that is no longer used. You would be worried that there could be some ongoing effects of labour and capital not being as fully engaged as they were previously. But I think the indications so far are that those effects are not as bad as you might have thought they could have been, so you could be reasonably optimistic we will get back to somewhere near where we were.

**Ms ADDISON:** Thank you for that. Can I just say that I was speaking to a local photographer—I live in Ballarat—and he said exactly that, ‘We will never recover from what’s happened, but our order book is now full’. That is certainly what I am hearing anecdotally as well, so thank you.

**The CHAIR:** Thank you, Chris. Kat, do you have a question?

**Ms THEOPHANOUS:** Thank you, Chair. I am conscious of the time so I will try to keep it short. Thank you, Chris, for the comprehensive evidence you have provided to us. I just wanted to seek your views on alternative models of horizontal fiscal equalisation that work in the Australian context, and whether you have got any views on that.

**Mr MURPHY:** Yes. I think, which you would have probably gathered from the presentation, that what I am calling the WA relief model, if you think in terms of economic reform, is a step backwards; it is inferior to the full equalisation model that we used to have. I think you could take a step forward, which would be to move to what I call the efficient equalisation model. But it is fairly close to the full equalisation model, and as you would expect, it does not include any special deal for any particular state. So that is definitely a bad feature of the new system—that there is that special deal for WA. That is very clearly part of it.

I would say going back to the old system would be better, but you can improve that old system in a couple of ways. As I said, I think equalising the cost differences from an economist’s point of view is not a particularly good idea. If it is more expensive to live in certain places, then arguably you do not want to fund state governments to cover those additional costs and encourage people to live in high-cost areas. That would be one thing. The other thing is rather than assess states’ capacity to raise things like payroll tax revenue based on their actual labour income, it is better to step back and ask, ‘Well, what is the population hand each state has been dealt? What’s the demographic profile it’s dealing with?’—so, if you like, what it should be able to raise in payroll tax from its demographic profile—rather than looking at the actual tax base, which could be influenced by a whole range of other things, such as whether there is good economic management, for example, or not. You do not want to equalise between states for bad economic management. So with those two qualifications you could tweak the system so you are not compensating for high costs, so you are not compensating for sort of bad economic management, but that would still leave you with a system that is fairly close to the old full equalisation system. So I think, as I said, 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.

**Ms THEOPHANOUS:** Thank you.

**The CHAIR:** Thank you very much. I think that we could conclude. Is there any other question that anybody would like to ask? All right. Thank you very much for being with us today, Chris. It is very valuable information that you have provided to us.

**Mr MURPHY:** Thank you for the opportunity to participate.

**The CHAIR:** Thank you for being here. Thank you.

**Committee adjourned.**