

TRANSCRIPT

LEGISLATIVE ASSEMBLY ECONOMY AND INFRASTRUCTURE COMMITTEE

Inquiry into Commonwealth support for Victoria

Melbourne—Wednesday, 15 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

WITNESSES (*via videoconference*)

Mr David Martine, Secretary,

Mr Chris Barrett, Deputy Secretary, Economic Division, and

Mr Andrew Witchard, Executive Director, Revenue Group, Department of Treasury and Finance, Victoria.

The CHAIR: Good morning, and welcome to the hearings for 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. Could I please remind members and witnesses to mute their microphones when not speaking to minimise interference.

I invite you to make a brief 10-minute opening statement—I think you have got a presentation to make to the Committee—and then we will ask questions accordingly after that. Thank you for being with us this morning.

Mr MARTINE: Thank you, Chair and Committee members, and thanks for the invitation to present to the Committee this morning. I should introduce myself: David Martine, Secretary of the Department of Treasury and Finance. I have with me Chris Barrett, who is the Deputy Secretary, Economic Division, and Andrew Witchard, who is the Executive Director, Revenue Group. I do have a presentation, which I understand the secretariat is going to put up on the screen.

Visual presentation.

Mr MARTINE: If the operator can perhaps move to the first slide. Great, thanks. Victoria has long supported the principle of horizontal fiscal equalisation, or HFE. HFE ensures the ability of states to provide similar levels of services and infrastructure to their residents. Australians should not be disadvantaged for their choice of where to live. The overall quality of government services should not influence people's decision of which state to live in. In fact Victoria has subsidised other states since the inception of the GST system in the year 2000. As an economically and financially strong state it is reasonable to expect Victoria to assist other states.

The aim of the GST system is to achieve HFE. The Commonwealth Grants Commission calculates the distribution of GST in line with the principles of HFE each year. It uses a complex formula to account for differences in states' abilities to raise revenue and provide services. Next slide, please.

Approximately 24 per cent of Victoria's revenue comes from GST grants. GST is an important part of Victoria's revenue base, and its equitable distribution between states is critical to fund services for Victorians. Another quarter of Victoria's revenue comes from other Commonwealth funding sources, including payments for specific purposes. In total around half of Victoria's revenue comes from the Commonwealth. Within this is funding for infrastructure. Despite having 26 per cent of Australia's population, Victoria only receives 22 per cent of Commonwealth infrastructure investment. This represents a shortfall of \$4.2 billion over five years to the year 2023–24 compared to if Victoria received its population share. Next slide, please.

Since the introduction of the GST in the year 2000, Victoria's GST revenue has grown most years. This is primarily due to growth in the GST pool and population. The strong increase in GST revenue for 2020–21 is driven by growth in the national GST pool, owing to a faster than anticipated recovery in consumption from the impacts of the coronavirus pandemic. Since 2018–19 the CGC has assessed Victoria's fiscal capacity to have improved, meaning its GST relativity has trended downwards from 0.99 in 2018–19 to 0.92 in 2021–22. This has put downwards pressure on Victoria's GST revenue. Looking forward, Victoria's recently upgraded own-source revenue and slower population growth are expected to continue to apply downward pressure on Victoria's GST relativity. Next slide, please.

Historically Victoria has contributed to HFE, subsidising other states through the GST system. Victoria has never received its population share of GST. This is reflected by its GST relativity sitting below 1.0 since the start of the GST in the year 2000. The CGC estimated that in 2021–22 Victoria received \$2.1 billion less than it would have if the GST was distributed by population share. This went towards assisting Queensland, South Australia, Tasmania, the ACT and the Northern Territory, which all received greater than their population share of GST. Next slide, please.

While Victoria supports HFE, funding must be calibrated to ensure Victoria is not disadvantaged for being a fiscally stronger state. According to recent budget figures Victorians have access to the second-lowest total government revenue per person, adding state and Commonwealth sources together. Next slide, please.

In 2018 the Commonwealth legislated changes to the GST system, following a Productivity Commission inquiry into HFE. The system the Commonwealth legislated made significant changes to the GST system, which have compromised the underlying intent of the HFE system and have seriously undermined its operation. The new system is being phased in over a six-year transition period. Key features include a new, lower standard for equalisation, a floor on GST relativities and top-up payments to the GST pool. Next slide, please.

A key change under the new HFE system legislated by the Commonwealth in 2018 was to revise the standard for equalisation. Previously each state was provided the fiscal capacity to deliver services and infrastructure to the same standard if each pursued average policies. This resulted in all states enjoying similar fiscal capacities to deliver services to their citizens. The new standard, however, implements only a partial equalisation to deliver the quality of services of the stronger of New South Wales or Victoria. This means any state with a greater capacity than New South Wales or Victoria retains its advantage. For the foreseeable future only Western Australia is expected to benefit from this new standard. This results in the majority of jurisdictions receiving less than they would have under the long-established previous GST system. Next slide, please.

In its initial response to the Productivity Commission report in 2018 the Commonwealth argued that all states would be better off under the new system. No legislative guarantee was offered at the time. However, it was clear even in 2018 that many states could be worse off and receive less GST from the new system than they would have under the previous system. With Victoria leading, a number of states worked together and presented modelling to demonstrate that all states other than Western Australia would likely be worse off under the new system.

In response the Commonwealth finally committed to legislating a no-worse-off guarantee but only until the transition is complete in the year 2026–27. The Commonwealth's 2021–22 budget now estimates it will pay \$7.6 billion in no-worse-off payments to the states over the budget and forward estimates period, which is a four-year period. This includes \$2.3 billion to Victoria alone. Western Australia has no need for no-worse-off payments, as it significantly benefits from the new system. The Commonwealth's 2021–22 budget notes it will pay WA \$2.1 billion in 2021–22 alone in transition payments to establish the relativity floor and new standard of equalisation. Next slide, please.

In 2018 the Commonwealth's forecasts suggested all states would be better off from the new system. They argued there would be no need for no-worse-off payments. However, these forecasts made at the time have proven highly inaccurate. Due to the recent growth in iron ore royalty revenue, with the price of iron ore reaching historic heights, Western Australia's GST relativity has declined. Western Australia's strong budget position increases the cost of the new system, as it requires greater compensation to lift its GST relativity to the floor or to the new equalisation standard. According to the Commonwealth's most recent budget the total cost of the new system will be over \$10 billion from 2019–20 to 2023–24, significantly greater than the \$3.7 billion originally estimated by the Commonwealth in 2018. Next slide, please.

The no-worse-off guarantee is currently legislated only until the end of the transition period in 2026–27. After this, states will be exposed to significant financial impacts. To test the current forecast, DTF has conducted sensitivity analysis by modelling a range of scenarios to test the potential financial impacts on states of the new system. The scenarios were chosen to provide a wide range of potential outcomes. The modelling shows in each scenario Victoria is estimated to be worse off under the new system, compared to the former system, after the guarantee is set to expire. For example, if relativities return to their 10-year average, which is a plausible scenario, Victoria will be \$1 billion worse off in GST revenue in 2027–28 alone. 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. Next slide, please.

GST is a vital source of revenue for Victoria, and its distribution between states is consequential to the level of services state governments are able to provide. However, the Commonwealth Government's legislated changes in 2018 have now compromised the underlying intent of the GST system and have undermined its operation. The new system is now costing the Commonwealth Government billions of dollars annually, costs that are set to fall to states once the no-worse-off guarantee ends in 2026–27. Victoria will continue to advocate to the

Commonwealth for changes to the current system by either making the no-worse-off guarantee permanent or reversing the changes and reverting to the former system. The South Australian Treasurer, the Honourable Rob Lucas, has recently commissioned an inquiry into the new GST distribution arrangements, which will review its impact on state and territory GST shares. This is ahead of the legislated review by the Productivity Commission in 2026. The South Australian review is being supported by Victoria, New South Wales and other states. Thank you, Chair, and we are happy to take any questions the Committee members may wish to ask.

The CHAIR: Thank you, David. Can I kick it off by asking a question about various assumptions that were obviously made in relation to this issue. Under what assumptions did the Productivity Commission and the Commonwealth suggest that all states would be better off under the new GST system, and why have the assumptions proven to be incorrect?

Mr MARTINE: Thanks, Chair, for the question. The modelling that the Commonwealth relied on came out of the PC report in 2018, and in that report, based on the modelling, it was presented to us all that every state would be no worse off. So, for example, for Victoria we were told that we would be \$425 million better off up to the year 2026–27. The problem with the modelling was that it was based on relativity forecasts that have proved incredibly inaccurate. The way the GST works is it is a function of the size of the GST pool—that is driven by consumption spending—your population share, and Victoria sits at about 26 per cent of the Australian population, and your relativity. A relativity less than 1 means that you are not getting back as much GST as Victorians actually provide, and we have always been lower than 1 because we are a financially strong state.

The problem with the modelling was that the relativity forecasts used, particularly for Western Australia, have been proved highly inaccurate. For example, the PC assumed that the relativity for Western Australia, which was at the time around 0.47, would actually increase by the year 2026–27 to 0.76, which in effect would actually be just above the floor that was set by the Commonwealth—in other words, it would not really cost the Commonwealth anything by introducing that floor, because they were forecasting Western Australia to go above the floor.

In reality the Commonwealth's own recent budget in May of this year, which started at 0.47 for WA, in the year 2024–25, which is the last year in their budget, was actually forecasting WA's relativity to fall to 0.33. So in fact rather than the Western Australian relativity increasing over that period, it has actually fallen to 0.33, and that is driven by particularly very strong iron ore prices, very strong prices on resources, which means 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. So that is why we all pushed strongly for the legislative guarantee.

The CHAIR: Thank you. Nick, did you have a question?

Mr WAKELING: Yes. David, thank you very much for your presentation. Can I just bring you to the Commonwealth Grants Commission. What changes or improvements do you think they can make to their methodology for assessing the states' distribution? I would be keen to know your thoughts on what changes they could apply.

Mr MARTINE: Thanks for your question. The way the Grants Commission works, it is an incredibly complex calculation they do. Effectively what they try and calculate is: what is the appropriate level of revenue that a state should raise, and what is an appropriate cost for providing services in that particular state? For some states the cost of providing some services is more expensive than other states. For example, in the Northern Territory providing health services in remote areas costs a lot more money than what it would cost us here in Victoria. So it is quite a complex system they go through, and every year we engage with the CGC and have discussions with them about what the average cost is of providing infrastructure, health services, other services in Victoria, for example. On this particular issue the biggest change that I think we need to push strongly for as a state is the continuation of the no-worse-off guarantee, which is not really a Commonwealth Grants Commission issue. That is really a decision of the Commonwealth Government, and at the moment they have only committed to the year 2026–27. That is the biggest risk we have on GST.

The other issue, just coming back to the Grants Commission, that we are currently engaged with them on at the moment is how they are planning to treat COVID-related expenditure. It has been, not surprisingly, different across states and territories. Victoria and New South Wales have spent the most on COVID-related expenditure as a result of lockdowns, both business support and extra funding for health systems. That has been quite variable and obviously less in Tasmania, Western Australia et cetera. So we are currently in discussions with the Grants Commission on how they are planning to treat those payments in relation to then how it impacts on GST distribution. Our position is that it should be taken into account in terms of the GST distribution. For example, the more you have been forced to pay out in terms of COVID-related expenditure, that means you should get some GST compensation back. That is really the main issue we have got with the CGC at the moment.

The CHAIR: Thank you. Chris, did you have a question?

Ms COUZENS: Yes, thanks, Chair. Thanks, David, for your time and contribution and that of your colleagues today; we do appreciate it. What impact will the new GST system have on Victoria's economic recovery following the COVID-19 pandemic, and in particular the impact on women?

Mr MARTINE: Well, first of all, the Victorian economy has proven pretty resilient. We did see quite a strong bounce back last year when we first came out of lockdowns, to the point where if you looked at, for example, the jobs data by the end of August, there were more Victorians employed at the end of August last year than prior to COVID hitting us back in March of 2020. So the economy bounced back strongly. Obviously with the restrictions starting in August, September and October last year we have fallen back. We are very optimistic about the strength in the Victorian economy and recovery. Obviously tied in with the recovery of the economy we need to also see the recovery in the state's fiscal position, and GST is an important part of that. GST will bounce back with consumption spending increasing. There were a lot of—not surprisingly during lockdowns—consumers finding it difficult to spend. That is bouncing back strongly, and the recent data we have seen since the lockdowns were lifted shows that has come back strongly both here and in New South Wales as well. So we will see the GST pool increase.

As I indicated earlier, the GST is the function of three components: the size of the pool, your population share and the relativity. Population growth has been an important part of economic activity here in Victoria, so we are forecasting lower growth, particularly this year and next, and then slowly increasing to, I think from memory, around 1.5 per cent growth. It will be quite important from an economic point of view to get the international borders reopened, as they are just starting to do now, and getting the flows of migrants and international students back in to help support the Victorian economy, so that will help contribute to GST.

Just coming back to the last bit of your question, I guess, about gender, it was quite interesting: looking at the data, particularly through the course of last year when COVID first hit and we first went into lockdowns, there was a greater impact on female workers than male workers. That is what we sort of saw in the data. But what was really encouraging in the back half of last year as we came out of lockdowns and the economy recovered was the strength in employment for females. Actually we ended up in a situation where more females were employed than we had just prior to COVID, and part of that was a strong participation rate, with more females entering the market, or the employment sector. So I think COVID has sort of hit particularly the female cohort, but it has bounced back reasonably well.

The CHAIR: Very good. Kat, did you have a question?

Ms THEOPHANOUS: Yes, Chair, thank you. And thank you, David, and your team for the detailed submission. Your submission suggests bringing forward the Productivity Commission's scheduled 2026 review of the system. Has Victoria or any of the other states asked the Commonwealth to bring the review forward, and if so, what was the response? And I guess in addition to that, is there an ideal time to undertake this review?

Mr MARTINE: Thanks for your question. We have asked, and the answer so far has been no, which is why the South Australian Treasurer has announced that they are going to undertake a review now. That review has commenced, and we are helping them with modelling. We did a lot of the modelling back in 2018.

It is important. 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. At the moment their position when they do their medium-term modelling is always undertaken on current government policy, and given the current Commonwealth policy is they have made no decision on extending the guarantee, then the Commonwealth Treasury’s medium-term modelling assumes that it is not continuing.

Those years will start appearing in our budget papers, which is why it is important for certainty—because you need to budget over the medium term—that all states and territories get more certainty now about what is going to happen with the guarantee. Because based on current numbers—based on the Commonwealth’s own numbers, which are disclosed in the most recent budget papers—they are paying now significant payments annually as no-worse-off payments. So, for example, in their budget papers that were released in May of this year, budget paper 3, page 100, there is a table 3.8 which discloses the payments. They increase in the year 2024–25, which is the last year in the budget; it is \$2.7 billion alone that they are paying to all states and territories other than WA as part of the no-worse-off guarantee. So we do need this issue dealt with now, which is why the South Australian Treasurer has kicked off their own review, which we are helping support along with other states.

Ms THEOPHANOUS: Thank you.

The CHAIR: Excellent. Just in relation to that, obviously when the no-worse-off guarantee expires there will be an impact on the provision of public services: how will it have a dramatic impact on that?

Mr MARTINE: Well, it obviously will depend at the time on the amount that we are worse off by under that system compared to the old system. As I indicated in my opening statement, we were all told at the time that everyone is going to be better off et cetera. You know, it is hard to forecast out that far, which is why we have run a whole range of different scenarios that I presented in the slides that you should all have, and we have tried to be as balanced as we can and run all sorts of different scenarios. But if I pick a very plausible scenario, which I outlined in my opening statement, where relativities return to just their 10-year average—which is not an unusual thing to do as a modeller; often when you are doing modelling it is very hard to predict the future, so you sometimes look at the past to say, ‘Well, if we assume a 10-year average, that’s where we end up’—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.

The CHAIR: Thank you. Nick?

Mr WAKELING: Thanks, Chair. David, can I just pick up on your earlier comment regarding South Australia. Rob Lucas, I think you mentioned, is undertaking a review. Do you know if the scope of their review is similar to this or do you know what the scope is, and do you know the reporting time frames on that review?

Mr MARTINE: I think, from memory, they are looking to report in the new year. I cannot remember the exact month, but if you work backwards, I think they have an election in March, from memory, so I am pretty sure their Treasurer is looking to have their review finalised and publicly released before then, to enable public discussion. So it will be, I understand, finalised in the new year. It is very much looking at the impact of the new system on the GST arrangements, which is why we are helping out our South Australian colleagues with input to the modelling at where we are now. We took the lead in a lot of the modelling back in 2018 and presented it. There was a Senate committee that was looking at the legislation at the time. We went up to Canberra and presented the modelling. So we are helping them out on the modelling, but they are looking to finalise and release in the new year.

Mr WAKELING: Thanks.

The CHAIR: Thank you. Any further questions? Chris Couzens.

Ms COUZENS: Thanks, Chair. I am interested in your view on the level of Commonwealth investment in Victoria's infrastructure.

Mr MARTINE: Yes, happy to answer that. I will just find my data. I think I made this comment in my opening statement. Victoria is roughly about 26% of the total population, so if we were receiving our population share of Commonwealth grants for infrastructure, we would expect to receive about 26% their funding. Now, 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 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.

The CHAIR: Thank you very much. Any further questions? Kat?

Ms THEOPHANOUS: Thanks, Chair. David, in the WA government's submission they question modelling around scenarios on the basis that they are using a higher iron ore price assumption than the WA and Commonwealth budgets. Do you have any commentary on that or any response to that?

Mr MARTINE: Yes, I am happy to address that. 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, so they believe a return to a long-run average; 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 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.

Ms THEOPHANOUS: Thank you. I think we might have lost our Chair. It seems like it.

Mr WAKELING: Well, Chris or Kat, no other comments from you? Without the Chair, can I thank you for your presentation today and ask that if we have any further questions we will be able to send those to you through our secretariat.

Mr MARTINE: Yes, I am happy with that. If you have got any further questions or clarity or anything that we are—

The CHAIR: Sorry about that. My internet dropped out. I am working in Geelong.

Mr WAKELING: I jumped in quickly for you, John. We were wrapping up on your behalf.

The CHAIR: Okay, no worries. So no more questions, then? No. All good. As Nick said, we will write to you if we have got further questions. Thank you very much for your time and your submission.

Mr MARTINE: Yes, no problem. Thanks, everyone.

Witnesses withdrew.