

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 Saul Eslake, Economist and Principal, Corinna Economic Advisory.

The CHAIR: Thank you very much for your attendance at these 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 be ultimately 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 opening statement, and then we will proceed with questions from the Committee. Thank you very much for being here.

Mr ESLAKE: Thank you, Chair, and I appreciate the opportunity and privilege of speaking to your Committee and its important inquiry, especially given that I am no longer a Victorian resident, although I was for what is still about half my life, between 1983 and 2015, and I retain a great deal of affection for Victoria.

I have provided a submission to the Committee, and it is probably not a good use of your time for me to go over that in great detail. But the main points of it are that the changes to the GST revenue sharing arrangements that were imposed by the Commonwealth Government on all states and territories three years ago and which are now being phased in over the five years between the current financial year and 2026–27 have, as was their deliberate intent, the effect of giving Western Australia a bigger share of revenue from the GST than it would have obtained under the principles that have been in force for the distribution of federal general revenue assistance to all states and territories since 1981 and indeed on principles that were first established by the Grants Commission in the 1930s, shortly after its establishment in the aftermath of the referendum at which Western Australians voted to secede from the Commonwealth in 1933.

The key point I want to make here is that those principles—that citizens of all states and territories should have access to similar standards of state-type public services, such as education, health, policing, social housing, child protection and the like, whilst paying broadly similar amounts per head of population in state taxation—were principles which worked to Western Australia's benefit for almost 70 years after the Grants Commission was established, because those principles recognised that the costs of providing those types of public services in a state with such a large land area and a relatively small population scattered across it were greater than the costs of providing those services in more densely populated states with larger populations, such as New South Wales and Victoria. Whilst for much of that period Western Australia's capacity to raise revenue was less than that of the eastern states and territories, 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. After 15 years of complaining about this and wanting the rules which had served it so well when it was a poorer state than the national average changed, and following the Liberal Party's loss of government in Western Australia at the election in that state of March 2017, the Federal Government, with Scott Morrison as the Treasurer, commissioned the Productivity Commission to undertake an inquiry with terms of reference that almost guaranteed that it would produce an outcome favourable to Western Australia.

The Productivity Commission's report was uncharacteristic of the Productivity Commission's longstanding tradition of basing its conclusions on a disinterested reading of the evidence before it, in contrast to the findings that had previously been made by a committee established by former federal Treasurer Wayne Swan that included former Victorian Premier John Brumby and former New South Wales Premier Nick Greiner, which found there was no evidence to back up the assertions that Nick Greiner and John Brumby had previously made when they were premiers of their respective states, and have been made more recently by Western Australia,

that the previous system of distributing GST revenues on a horizontal fiscal equalisation basis had discouraged states from adopting productivity-enhancing reforms. The Productivity Commission could not find any evidence of that either, but nonetheless said that the absence of evidence did not imply evidence of absence—the same logic that was used by George W Bush, Tony Blair and John Howard to support the invasion of Iraq in 2004. In other words, Richard Butler, despite spending almost 10 years looking for weapons of mass destruction in Iraq, could not find any, but according to the Bush administration and the Blair and Howard Governments that did not mean Saddam Hussein did not have any. Well, of course we know how truthful and reliable that conclusion turned out to be.

Anyway, on the basis of that inquiry the Morrison Government imposed on the states and territories in 2018 a new system of GST distribution which differed from the longstanding one in two important ways: one, that it would no longer seek to raise the fiscal capacity of the states and territories to that of the richest state, which is now Western Australia, but rather to the stronger of New South Wales or Victoria; and secondly, irrespective of whatever might come from a distribution of GST revenues on that basis, no state would get less than 70 per cent and subsequently 75 per cent of what it would have obtained under a notional equal per capita distribution of those GST revenues. Both of those changes work to the advantage of Western Australia. 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—in other words, 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. For the five years to 2026–27 the cost of this appeasement of Western Australia's greed falls to federal taxpayers, who have to fund the so-called no-worse-off guarantee that the Federal Government provided to other states and territories for the period up to 2026–27 when the new arrangements will have been fully phased in. That no-worse-off guarantee will, on the most recent set of forecasts published by the Federal Government, cost in excess of \$11 billion more than had been flagged at the time the deal was agreed in 2018. That is an extra \$11 billion that will be added to the Federal Government's gargantuan budget deficits in order to transfer a similar amount to the only government in Australia, and one of less than a handful in the world, that is running budget surpluses.

But after 2026–27, when as things currently stand the no-worse-off guarantee expires, the cost of appeasing Western Australian greed will fall to other states and territories, including Victoria, and the Victorian Treasury has provided public estimates of how much worse off Victoria will be as a result of that expiry of the no-worse-off guarantee. 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.

The last point I would make, Chair, is that although Victoria has traditionally seen itself as a donor state and has in the past under governments of both political persuasions at the state level argued for changes to the distribution of GST revenues towards a per capita distribution, because Victoria is no longer as rich relative to the rest of the country as it used to be—highlighted by the most recent state accounts, which show that Victoria's per capita gross product is actually now below the national average and Victoria's per capita household disposable income in 2021 was the second lowest in Australia, lower than Tasmania's and higher only than South Australia's—I would suggest that Victoria needs to rethink its longstanding position on issues associated with the distribution of general revenue assistance to states and territories and ought to consider the possibility that its interests are now more closely aligned with those of Queensland, South Australia, Tasmania and the Northern Territory than with New South Wales, as they have traditionally been, and more recently with Western Australia, whose pursuit of what is an unfair and overly generous allocation of GST revenues is now very much to the cost of the Victorian Government and ordinary Victorians.

The CHAIR: Thank you very much for that comprehensive assessment. The comments that you have made are very valid, and we thank you very much for them. I might kick off the questions. In light of all of that, what changes to the 2018 GST distribution reforms should Victoria be seeking?

Mr ESLAKE: Well, I think ideally it should be seeking a reversion to the previous arrangements—that is to say, first, that the goal of horizontal fiscal equalisation should be to lift the fiscal capacity of all states and territories to that of the richest state, which is currently and for the foreseeable future Western Australia, rather than to that of the second-richest state, which is New South Wales. Secondly, it should be seeking the removal of the floor under the GST-sharing entitlements of any individual state or territory which says that currently no state can get less than 70 per cent and from, I think it is 2024–25, less than 75 per cent of what it would have received under a notional equal per capita distribution of GST revenues—in other words, to undo the key elements of the deal that was imposed on the states and territories by the Morrison Government in 2018.

If that is not feasible, bearing in mind that at the federal level both sides of politics do not want to offend Western Australia, because of the crucial importance to both sides' prospects at the forthcoming election of either holding or winning some of the 14 House of Representatives seats that come from Western Australia, then I think the next best options for Victoria to pursue are: first, to bring forward the Productivity Commission inquiry that is meant to take place in 2026 to examine whether the new system is working effectively; second, to demand that the states and territories—in particular in this case Victoria—have some input into the terms of reference for that inquiry so that they are not biased towards producing an outcome favourable to Western Australia, as the 2017 inquiry's terms of reference were; third, that the Victorian Government should also seek some say in who conducts that inquiry, rather than have it conducted by, as I think it was, people who were inclined to do the Commonwealth's bidding, which in turn was very much to appease Western Australia.

The fourth thing that the Victorian Government could do would be to ask, if not demand, that its representatives in the Federal Parliament—its members of the House of Representatives and its senators—be much more forthright, to the point if necessary of voting accordingly on any legislation that comes before the Parliament, in upholding Victoria's interests. It is my understanding that when he was Treasurer the current Premier of New South Wales wrote to New South Wales senators and members of all political parties asking that they be more forthright in their defence of their state's interests in Parliament, rather than simply voting along party lines. I am not aware that the Victorian Premier or the leaders of parties in the Victorian Parliament who have counterparts in the Federal Parliament have done the same thing.

The CHAIR: Thanks very much for that. Gary, do you have a question?

Mr BLACKWOOD: Yes, thanks, Chair. And thanks, Saul, for your presentation. Saul, what is your view of the level of Commonwealth investment in Victorian infrastructure?

Mr ESLAKE: It is not something I have examined closely, but I am aware of longstanding perceptions that other states and territories, particularly New South Wales and Queensland, have done better out of the distribution of Commonwealth capital funding than Victoria has done. Now, in my view, 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 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.

Mr BLACKWOOD: Thanks, Saul. Excellent.

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

Ms COUZENS: Thank you for your contribution today. It is appreciated. What changes to the 2018 GST distribution reforms should Victoria be seeking?

Mr ESLAKE: I think I answered that in response to the Chair's question, but let me just summarise that again briefly. The ideal would be completely to unpick that deal and revert to the arrangements that had applied not merely since the introduction of the GST in 2000 but in fact applied to the distribution of general purpose grants to states and territories from 1981, when the previous system was introduced by the Fraser Government.

The principle behind that distribution, which had applied for the best part of 40 years, was that revenue since 2000 from the GST, prior to that general purpose or financial assistance grants to states and territories, should be distributed in such a way as to raise the capacity of each state and territory to provide services to its citizens to that of the richest state, which for a long time was either Victoria or New South Wales but since about 2004–05 in almost every year since then has been Western Australia. So that principle should be reinstated. The floor below a state's relativity—that is, the share it gets off GST relative to its share of the population—that was introduced in the 2018 deals, which is part of why it becomes a win-win outcome for Western Australia no matter what happens to the iron ore price, should be removed as well and the system should revert to one that has served Australia so very well.

Perhaps if I could just expand on that a little bit to something I think I say in my written submission, Australia does go further than any other democratic federation in seeking to equalise the fiscal capacity of its subnational governments—its states and territories, or provinces as they are called in some other federations. We do that much more comprehensively, which we can do because there is a greater degree of what economists call vertical fiscal imbalance in the Australian federation—that is, the Commonwealth Government has far greater revenue-raising powers than it needs to fund its expenditure responsibilities. Correspondingly, because of the way the constitution has been written and the way it has been interpreted over the decades by the High Court, states and territories have less capacity to raise revenue than they have responsibilities to fund services, and that has been resolved in Australia by the Federal Government making significant grants to each of the states and territories. We have done that in a way over time that 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. And in large part as a result of that, the gaps in living standards and economic and social opportunities between the residents of Australia's poorest states and the residents of Australia's richest states—say, between Tasmania and Western Australia—are much smaller than the corresponding gaps between people who live in, for example, Mississippi and Massachusetts in the United States, or in Newfoundland and Alberta in Canada, or even between the richest states in Germany, Bavaria and Baden-Württemberg, and the poorest states in Germany, which are those in the former East Germany.

And I would say this is a desirable aspect of Australia's system of government—that there are fewer disparities in living standards and economic opportunities across Australia's different regions than there are in almost all of the other countries with systems of federal government like we have—and the way in which federal grants to the states have been carved up over more than 70 years has been a big part of that. And the changes imposed by the Morrison Government three years ago, in what I have often called a corrupt bargain, unpick that longstanding principle of the distribution of grants among states and territories within Australia that has over time made an important contribution to us being a less unequal place than we would have otherwise been.

The CHAIR: Thank you for that comprehensive answer. Nick, do you have a question?

Mr WAKELING: Yes. Thank you, Chair. Saul, can I just bring you to the area of horizontal fiscal equalisation? I would be interested in your views of what you see as being the ideal model, particularly when we are focusing on issues around productivity, efficiency and economic growth. I would be interested in your views.

Mr ESLAKE: Mr Wakeling, 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.

Now, it has often been alleged over the last 30 or more years that the distribution of Commonwealth grants to states in accordance with fiscal equalisation principles has blunted the incentives that states and territories face to introduce productivity or economic growth-enhancing reforms on their own. In other words, the argument has been that poorer states, states which benefit from horizontal fiscal equalisation, have been reluctant to introduce reforms such as the replacement of stamp duties with a broadly based land tax or reforms to their payroll tax system for fear of losing GST revenues. The same argument has been made with regard to rich states, for example, so it has been said.

Nick Greiner and John Brumby used to say, when they were premiers of their respective states, that the system of horizontal fiscal equalisation discouraged them from pursuing productivity or growth-enhancing reforms to their systems of state taxation. Indeed, in the early 2000s, the Victorian, New South Wales and Western Australian Governments commissioned an inquiry by Vince Fitzgerald and Ross Garnaut, two very respected Australian economists, which said that, although Messrs Garnaut and Fitzgerald were not able to produce any hard evidence to support that assertion—they were not able to point to any occasion when a state or territory government which had been contemplating some kind of productivity-enhancing reform had decided not to pursue it for fear of adversely affecting their share of GST revenues. It is very much to the credit of the intellectual integrity of John Brumby and Nick Greiner that when Wayne Swan asked them to investigate the same question in 2012 they admitted that the arguments that they put when they were premiers of their respective states did not have any evidence to support them, and they found that there was no evidence that horizontal fiscal equalisation provided a perverse incentive against the adoption of productivity-enhancing reforms to state tax systems.

The most recent Productivity Commission inquiry, which was conducted by Karen Chester and Jonathan Coppel as the lead productivity commissioners, could not find any evidence of that either. But, as I said in my opening statement, they nonetheless said the absence of evidence did not mean evidence of absence and proceeded on the basis that they had found some evidence, even though they admitted that they had not, to make recommendations which, as I say, were primarily to the benefit of Western Australia and at the expense of other states and territories. I mean, I live in a poor state, Tasmania. There has never been any suggestion in my 40 years of following political developments in Tasmania of a state government choosing not to do something that would make Tasmanians better off, that would increase employment or economic growth or investment in Tasmania, for fear that Tasmania's share of the GST revenue would therefore be adversely affected. It just simply has not happened and, as I say, it is very much to Nick Greiner's and John Brumby's credit that they had the intellectual integrity to acknowledge that when they were formally asked.

The CHAIR: Thank you, Saul, for that comprehensive answer. We are running out of time. I am going to suggest that we put some questions to you in writing and if you can answer them back that would be great, unless other MPs have questions that they want to raise now. Juliana or Kat, do you have anything that you wanted to raise?

Ms ADDISON: Chair, could I say that if we are putting questions in writing, I would be keen to seek Saul's views on how the Commonwealth could better support local government. That is an issue of interest to me.

The CHAIR: Okay. Do you want to answer that, Saul, before we wrap up?

Mr ESLAKE: In simple terms, and I am conscious, Chair, that you said you are running out of time, the most obvious way would be for governments to provide bigger grants through the states, as they currently, do for distribution to local governments ironically in accordance with fiscal equalisation principles. For a long time, I think since the late 1970s, the Federal Government has provided grants to local governments and required states to set up state grants commissions that in turn distribute that money to local governments on the basis of 30 per cent equal per capita and 70 per cent in accordance with similar principles to those used by the Commonwealth Grants Commission to determine the allocation of GST revenues among the states and territories.

So the simplest answer to the question that Ms Addison raised would be for the Commonwealth Government to provide bigger grants for that purpose. The Commonwealth could perhaps, although we would again have to do it through the states and territories for constitutional reasons, consider providing capital grants to local governments that were facing severe infrastructure spending needs because they were experiencing rapid population growth, for example. But again, that would be something that would really be solely determined by

the Commonwealth Government. I cannot think of any other reforms, for example, to the federal taxation system, that would be of assistance to local governments unless you were prepared to adopt the United States model where taxes paid to state and local governments were a deduction against federal tax. So if the Federal Government said that local council rates could be deductible against income tax, then presumably local governments could put council rates up, knowing that the people who had to pay them would in most cases be able to offset that against their federal income tax payments, but, as we are seeing in the current debate in the United States now about reinstating some of those deductions, that can have some quite controversial distributional implications as well.

The CHAIR: Thank you very much. Thank you very much for being here. We will write to you with any further questions if that is okay.

Mr ESLAKE: Absolutely.

The CHAIR: Thank you so much. We really appreciate your input today. Thank you for being here.

Mr ESLAKE: Thanks, Chair. I appreciate the opportunity.

Witness withdrew.