

ECONOMIC DEVELOPMENT AND INFRASTRUCTURE COMMITTEE

Inquiry into state government taxation and debt

Sydney — 29 October 2009

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Professor N. Warren, Head of School, Australian School of Taxation, University of New South Wales.

The CHAIR — I welcome Professor Neil Warren to our all-party parliamentary committee inquiries into manufacturing and taxation. You are free to make comment on one or both, but we are primarily interested in your comments on taxation. You are free to make any comments you wish to make, and then we will move on to questions. The Hansard transcript will be provided to you in about a fortnight. Evidence given is protected by parliamentary privilege, but anything you say outside the room is not. Thank you.

Prof. WARREN — What I thought I might do was begin with I suppose some broad observation about what you are doing and planning to do, what has gone before and what is different now. To some degree it is indicating to you if you are going to differentiate what you are doing, how might you differentiate it, because as you would know numerous reviews into tax have taken place over the years not only at the Commonwealth level but quite a few at the state level: in Victoria in 2001; in WA quite a series of reviews were undertaken out of Treasury and so on; and the IPART review that we did here in New South Wales.

Now I suppose what really differentiates the environment is that we have the Ken Henry review, Australia's future tax system review, which is due to present its findings to the Treasurer in December, which I understand the Treasurer will respond to and a report will be released around March or something like that. Obviously this has implications for time lines in this review.

The CHAIR — I presume you are aware this was an upper house reference to us.

Prof. WARREN — Yes. I suppose what I wanted to do was to indicate that there are a number of things that are happening now, and the significant difference this time will be the Henry review, which will be coming out with its findings, and the government's response in the middle of your deliberations. My beginning statement is going to be fairly broad, and I will leave you to narrow it down with the various questions.

The questions I ask myself in these kinds of situations are: where does that lead this review, given where the Henry review is going; where is the Henry review going; and what might be the contribution that you make? Obviously this is going to be conjecturing, and I will give you my broad thoughts on where it is at from the things I have seen and heard from various individuals.

The first observation I would make is that I think from the various musings that Ken and others on that review team have done over the last six to nine months he is going to be talking about an endgame in terms of tax, where they would like to end up and what it might look like. I suppose if I reflect on our experience with the IPART review and I reflect on the Harvey review, it is quite interesting that in a sense the way I would distinguish the Harvey review is that the academics ruled in the Harvey review, so you got some very big brushstrokes which the government proceeded to ignore.

I suppose the IPART review had a more immediate, practical sort of focus. There the focus was really on what can be done more short term. There were a lot of deliberations that I was involved in in the longer term and some structural, but they were not significantly brought out in the final report. What I suspect is that with Ken it is going to be much easier in that Treasury review to talk about what the states do, because it is much easier. I suppose the lesson when you look at all those previous state reviews is that it is a very sensitive issue to talk about your own backyard but it is very easy to talk about everybody else's backyard, and that goes for tax. I can talk about some of the broader directions that we looked at and thought about in the IPART review and that I suspect are going to be there in the future tax system review when it comes out.

Also one of my concerns these days as one gets further down the line and kind of reflects more — that is a gentle way to put it — is that — —

Mr DAVIS — It is called wisdom.

Prof. WARREN — It is wisdom to address potential cynicism. I suppose I have come to the conclusion that if you are really to talk about reform, in the beginning you have to address some of the institutional arrangements that you have. I suspect in the Henry review they will be leapt over with a huge jump and they will be looking at some ideal steady state down road, where there are a whole series of very interesting arrangements in terms of the various state taxes — revenue sharing, base sharing and so on — but with a very big question about how you get from A to B. I suppose that is in a sense where I would hope a review like your own would go to some degree to contribute, because that is where a contribution can be made.

That is very difficult territory, because you do not have to look very far to find what people think is wrong with property-based taxes and you do not have to look very far to find what they think the solution is. A and B can be an extremely long way apart. We had that issue in the IPART review. The statistics I always thought were very simple to present. You will remember that New South Wales moved to a zero threshold with its land tax for a very short period of time.

Mr DAVIS — Which did not stick.

Prof. WARREN — It did not stick. We have got about 2.7 to 2.8 million property holders, if you like — units of property in New South Wales. With the current land tax about 520 000 are subject to land tax. When they dropped the threshold it jumped to about 1.2 million. When people talk about broadening the base of the land tax, which is going to be floated, they are talking about a lot of people who are not currently paying tax. You can see the sensitivity of it in what happened in New South Wales when you doubled that number. That is the territory you have to go into if you are going to talk about conveyancing duty and your concerns about its impact on holdings in property and the immobility of individuals as a result of those stamp duties.

The same kind of issues arise with payroll tax. The payroll tax was given to the states in 1971 by the Commonwealth. It is fairly broad based and a pretty low rate. The states proceeded to push the threshold up, and now we have got a whole range of thresholds and different ways of administering those thresholds — Queensland is clawing back the threshold. At the same time you are seeing the Henry review talk about — and remember also that almost half of your payroll tax base is lost because of your threshold — moving to a wages tax à la no threshold, in effect, and potentially collected by the Australian Taxation Office. You also see that he gave a presentation to the offices of state revenue back in May of this year in which he questioned the relevance of offices of state revenue and the extent to which —

Mr DAVIS — That was probably popular with his audience!

Prof. WARREN — That is right! It is the same with the payroll tax. If you go to no threshold, there is also a lot of literature which says to roll it into the GST, which is what the Hewson Fightback proposal was. You can mount arguments for all of those changes, but they are a very big move from where we are at the present moment. There are also lots of issues around what I call benefits principle taxation, which is the user-charges, user-pays principle. In the IPART review we looked at incorporating that into our review and realised that there were well over 1000 of these in New South Wales alone. That in itself warrants a study. How are those prices set? There are those kinds of issues. You must remember that in some US states user pays and hypothecation is approaching 70 to 80 per cent of their revenue sources. It has become a very attractive one politically, because you can tie your revenue to an expenditure. Economists do not like it, because you typically raise more revenue than what you need for the particular purpose and then you skew your resource allocation on the expenditure side as a consequence of your ability to be able to raise a significant level. User pays is an important issue.

That in a way brings me to the Pigouvian-type taxes, which are the sin-type taxes. We have seen to some extent that Ken is making a lot in the review about transport, but many of these things they are talking about are in your domain and not in his domain. The question is: what is the

state's opinion about all these comments? There are a lot of comments about his particular domain. I will be interested to see the government's response to some of those issues.

Just moving to some of the institutional constraints, I see there are some significant institutional constraints on reform. One of them is obviously states themselves and the way that the states work together or do not work together — the old tax competition and the spiral-downwards principle. It is not surprising that with the IPART review we will be looking across what everybody else is doing. If you look at our interim report, we say the really good thing for government to do would be to lower the payroll tax threshold. If you look at the Harvey review in Victoria, you see they made all sorts of similar overtures, and there was the influence of John Freebairn and others, and governments will do exactly the opposite because the other states are doing exactly the opposite. The question is: how do you move on a broad front but still retain some of that discretion that states themselves want over their revenues? We can talk about some of that.

To me, at one level it involves the states themselves, and at another level, which I have been undertaking some research into, there is the role of the grants commission and the whole approach that the grants commission takes. I have real problems with that. It is not too hard to show what is the problem with it. The grants commission is undertaking a 2010 review now, but it is not a fundamental review; it is a cleaning-up review that they are doing there. What I have been saying in some of the things that I have published is that to some extent what we really want is to stand back from what we have got and question it, and not just assign the review to the grants commission itself to undertake, because that is not at arm's length. The Canadians can do it, the Austrians can do it, the Germans can do it; there are different types of models. There are different models out there.

Very simple things make very big differences. There are five-year relativities — there is a five-year annuated average that the grants commission works out for the year in which they are distributing. They are moving to a three-year annuated — the last three years now. If you look at the relativities over those five years, you would be quite astounded to see what has actually happened. Queensland and WA have streamed ahead of the other states. The Canadians have a similar kind of federation in the sense that they have got the very strong resource states and the not-so-strong resource states. They just exclude some of their provinces from the reallocation. They also have a three-year average, but they have 50 per cent weighted for the most recent year and then 25 and 25. That makes a very significant difference, even as simple as it is. It is a good move that they have moved to three years, but putting more weight in the most recent year means it is really reflecting what is actually happening on the ground.

In Western Australia and Queensland, with the global financial crisis, it was about to unravel for them. It would take a very long time before there was any adjustment to their grants to reflect that. The New South Wales property market had a significant influence on our relativities, and that market crashed in 2001 and 2002 and so on, and that has taken so long to flow through because the data they are using in the grants commission is up to seven years out of date. The review for the allocation for 2009, this year, is really for 2007.

Some of those things need to be reflected on as being impediments to reform. For example, there is significant health reform coming through, which has major implications for states and for the grant allocation. There is not enough understanding of what all of that means for the SPPs the states keep or for the GST pool, because if the Commonwealth is going to take over more responsibilities, then obviously the states will need less access to the pool and SPPs.

Where is all the really important analysis? Some of the states are doing some of that, and I am involved in some of that. That institution is important. COAG is really important in all of this because it is a forum where these issues can get discussed. The Council for the Australian Federation, which Victoria anchored for a while, is important in all of this. It is a forum that the states themselves can come to talk, whereas COAG is where the states and the Commonwealth can come and talk.

The other thing that is critical here — and it is the other favourite word; I have moved off this word to ‘institutions’, but it is equally important — is process. What is the process? Where are the time lines? Where is the mapping of getting between A and B? When you look at the IPART review you will see I kept saying, ‘We are going to date stamp everything’; even if you cannot achieve it, date stamp it. We talked about short, medium and long run. What are you going to do in two years? Report back at the end of two years on where you have got to. What are you going to do for three to five years? What are you going to do from five on? Because if you do not do that, you do not have any benchmarks to work up against and then you have to invoke the process to address it.

If you look at the recommendations in the IPART review, you will see that recommendation tucked away there, sometimes subtly, sometimes not. If we are talking about reform, it will say things like ‘We need to report’. Treasury needs to report in the parliamentary process. You get them to feed in and put more things on budget rather than off budget and those kinds of principles.

Process and institutions are important, because if you do not address those, you are not going to get from where you are to where you want to go. With all the best intentions in the world, if you cannot communicate to the politicians — yourselves — what is in it, you will not get where you want to go. I suppose the other critical thing in all of this is that you are not going to be able to do it by yourself as a state; you will have to work with other states and you will need a friend with deep pockets, and that is the Commonwealth. You can plan with the Commonwealth in the sense that they have set some benchmarks, but the question is: how do you work to those? But whatever dividends growth-wise that might come out of this, then the Commonwealth — and they have shown a propensity to do this in the past with competition payments and so on — has to become involved in distributing those.

Mr DAVIS — So to whom do the benefits accrue?

Prof. WARREN — Correct, and that is critical because this reform cannot be a zero sum game. It has to be a significant positive sum game, and I suspect what you will see coming out of Ken’s review is a lot of modelling that tells you about the positive sum game. The question is how do we get there and who gets the benefits, because the reform at the state level will benefit nationally, but it must also trickle down to the states as well. It is very broad brush.

The CHAIR — Thank you. I want to combine our manufacturing and tax inquiries. The question on which I am curious to hear your comments is in relation to government bonds, the advantage or disadvantage of them and how they could or could not or may be directed to ensuring manufacturing and jobs in Australia are advantaged by having access to finance. The reason I ask that question is that so much of what we have heard is that manufacturers have ideas and they have capabilities but in the current environment particularly it is very difficult to access finance to enable them to produce the goods for some of which orders have already been placed.

Prof. WARREN — This is not an area I have spent a lot of time in. I suppose one of the things you could do is reflect on some of the history of states working to support particular businesses. Victoria has some history in relation to picking winners and assisting particular businesses. Whether it sees itself in the role of replacing financial institutions where they might not otherwise want to go is a difficult one, because in my experience bureaucracies do not really want to be sitting in that position of being banker to the relatively high risk as much as the principal. It might sound good, and Victoria has had some difficulty with picking winners. This is going back some time, as you will remember. The difficulty for government is it is a lender of last resort.

Mr DAVIS — I thank you for that very good road map of lots of areas on which we can make some sensible suggestions, and I think that is where we have to focus. I was interested in your comments about charges and the 1000 user charges in New South Wales. We have had a similar thing in Victoria with automatic indexation being introduced as an extra-parliamentary process rather than the old principle of Parliament authorising new taxes or tax arrangements. Over the last

10 years we have had more than 20 or around 25 new or extended taxes and charges — for example, taxes on insurance levies for inbound flights, taxes on apprentice payroll and a whole range of different issues. I would be interested in your view about this and whether it is related to the issues of federal-state taxation.

Prof. WARREN — In our review — this is the IPART review — we spent some time working through and trying to come to terms with what is actually happening and why, and how you can go about systematically reviewing what has happened, because not only is there what is happening at the state level but local government has also got significantly into the user-charges environment. In our review we were getting a number of submissions. We were less worried about the states; we were more worried about local government, because that is where the impediment is starting in many cases.

We came to the view that this was getting beyond our terms of reference in the sense that it warranted a significant stocktake of exactly what was going on and why, and whether the hypothecation was the ingredient that was sitting there encouraging this to happen. It made it politically tenable — in other words, 'I am getting this; I am assigning it to this particular purpose'. So it kind of excuses it.

The other question we had was: what is the right pricing and what is the purpose? All of these, we concluded, after having drafted quite a bit of work and seen some internal documents that the Treasury itself was working through, warranted an examination in its own right. It is not simple, because there are so many of them and they are all for various purposes. In New South Wales they were not indexed in the way they were and are in Victoria. We had various things that needed to be done, and for a lot of these we just had not grasped the breadth of these.

What I am saying is that you need to look at those in their own right because potentially they are a significant source of revenue. Victoria was a significantly bigger user of user charges. It is very hard to find those numbers because those numbers are — —

Mr DAVIS — Squirreled away.

Prof. WARREN — They are squirreled away on the expenditure sides of budgets; you are just not seeing them. Part of the problem we had was trying to measure it, and then when we thought we were getting a handle on New South Wales, we realised there was a whole series of others — all the court fines, all of those things.

Mr DAVIS — So a useful step would be to have all of those quantified and reported in a transparent way and any hypothecation that has occurred to be made fully transparent?

Prof. WARREN — And a clear statement of principle: how they are determined and what is their objective. That will vary, but it was not stated. A department would find it had budgetary constraints, and it would find that it was effectively able to create imposts which would address their budgetary constraints without having to go to the revenue side to get an allocation. So there is transparency, and it is not just on the collection side; it is on the agencies. As you said, those questions need to be asked and the answers given. Transparency is the critical thing. It is not just transparent, but the number is getting significant in terms of — I have got a number in my head, but I will not say it — the proportion of revenue, these user charges are quite significant now.

Mr DAVIS — I have one further question. On that list of additional taxes and arrangements that have been put in place, I might send you that list and I would be interested in any thoughts that you might have on those sorts of taxes.

The CHAIR — Do you want it sent personally?

Mr DAVIS — No, I can do it either way, I do not mind. I am happy to provide a list and do it that way. But on the grants commission, I think you have made a lot of very good points.

The CHAIR — Can I make a suggestion: let us spend a bit of time on the grants commission and pursue that the whole way through after everyone has had a chance to ask a question on the topic they want to personally follow up.

Mr ATKINSON — I am interested in your observation that the trend in Australia is different to what it is around the world in the sense that taxation revenue is becoming more centralised, which is consistent with the ambitions of recent federal governments and the current federal government to actually take over everything in Australia and leave the state governments as post office boxes. I am aware that in Scotland, for instance, consistent with what you have said, they have had a review and suggested an income tax there. I am interested in teasing out further what that world trend is, and how you see that. There are the issues of taxation and representation; coming back to households there is the issue of he who holds the purse strings has the power. I am interested in the context in which you have set that out in your notes as well.

Prof. WARREN — It is a good question. Why has the world moved to increasing the use of decentralised frameworks, and we have moved to an extremely centralised framework? What is happening? The answer to that is: it really goes with a big push. I suppose it is what I would more generally call a democracy push and it is a devolution of government push. What it is saying, and you can see this if you look at the IMF type of reports about when the Iron Curtain came down, is that if you had put accountability and responsibility into those countries, when you are starting from a greenfield site, what do you do? The answer to that is that you have got to devolve down the expenditure, you have got to devolve down the revenue raising and you have got to get that accountability, because if you separate the accountability, then your democracy becomes vulnerable because that, between the citizen and what they are getting, is a break.

Again with Scotland, it had the North Sea oil; it was getting very upset that it was not getting its fair share; and with Wales it was the same sorts of things. What is happening is not new. What it is really about is responsible, accountable, transparent, democratic governments, and that is what it is about.

Why we have moved away from it is a really good point. It seems that the Commonwealth does not trust the states, and that the High Court itself has taken a very centralist role.

The CHAIR — You are protected by parliamentary privilege, but you probably do not want to go down that path.

Prof. WARREN — I have sat and listened to some discussions by some of the judiciary and been quite surprised. In fact one of them is on the public record, and I can locate the paper because he presented it to our institution, and he basically said it was they who decided; — it was not the Commonwealth or a state, it was the judiciary — about what was good for the nation. I was thinking that that was interesting; it is clearly a centralist line by the High Court, in its interpretation.

Mr DAVIS — From the engineers case on.

Prof. WARREN — Right the way back. It is nothing new, and it is the way the High Court works internally in terms of forming opinions and bringing together reviews. I was involved in the penultimate case when the states lost franchise, with the Queenslanders. What we did in that case was we went back, and it is interesting to go back and look at some of the debates over the constitution, but also go back and look at the public finance textbooks of the 1890s. When you look at that you can see exactly what the contemporaneous discussion was about the way the Federation would work, and it was along the lines of Canada and so on. But it has been overtaken. All of that has been overtaken by the High Court's stance, and so that is where it sits; its interpretation of section 90.

You need to have a section 90 because you do not want the states putting in customs duty because customs go with excise in the old tradition of the department of customs and excise, but we have

gone the full hog and taken out the GST. In fact a number of state taxes now are still vulnerable to section 90. Stamp duties on motor vehicles involve section 90; extrapolated payroll tax you can say is under section 90. You just keep pushing the boundaries of where the economic incidence of these things sit, and in the end what are you left with? The states raise 15 per cent of all revenue in this Federation at the present moment. That is not much. It is very different from other federations.

Mr DAVIS — As a follow-up to Bruce's point, it is not quite enough to blame the High Court either, is it? There have been examples where federal governments have sought to rebalance the arrangements. Malcolm Fraser had his new federalism and steps like that, and that is not alone. It is not just the High Court, is it?

Prof. WARREN — Yes, but the High Court, I suppose, has taken out the ability to do anything on the consumption tax side. Fraser's new federalism was really about piggybacking income taxes, so making room for states or allowing states to base share, which is essentially what he was talking about, so that you can put your own impost on. You do not need the High Court. The High Court does not say anything about income taxes. It is just really talking about section 90 there with customs and excise. That was the will of the states themselves to step into the breach and to impose their own taxes on their own jurisdiction.

However, it is probably worth pointing out that one of the things we looked at in our current review is, yes, states might want to do that, but the grants commission would very quickly unravel the purpose of that. If a state imposed it, say New South Wales, the assumption is the revenue would go back to New South Wales, but the grants commission would say that New South Wales has significant revenue-raising capacity and it would take away a large chunk of that and give it to the other states.

There are other institutions at play there that have to be addressed about what are we doing? What is our objective? Do all states need to be treated with HFE?

Mr ATKINSON — In terms of the devolution of taxes in other jurisdictions, apart from income tax are there any other taxes that are part of that devolution process that have an efficiency? One of our problems in state is that most of our taxes, as you said, the collect is fairly low, but more importantly, they are actually fairly inefficient because the cost of collection is high in relative terms. Are there any other taxes that have been associated with that devolution process overseas?

Prof. WARREN — In terms of?

Mr ATKINSON — Apart from income tax?

Prof. WARREN — Yes. Most jurisdictions will have property-based taxes. That is not devolved down. In the US that is how they fund education and a lot of the local services are funded out of that base.

Mr ATKINSON — And they also have a state sales tax, too.

Prof. WARREN — They have state sales taxes, that is right, which are point-of-sale taxes and where the rates vary, 7 to 10 or 11 per cent and it is a single-stage administered at point of sale.

Mr ATKINSON — What do you think the High Court's view would be of a state sales tax?

Prof. WARREN — It would not allow it.

Mr ATKINSON — Yes, that is what I would have thought.

Prof. WARREN — It is just not a possibility. There has not been that devolution with property taxes; that is where they reside.

Mr CRISP — I noticed in the IPART review you looked at what were effective taxes and what were not effective taxes. We heard some evidence earlier today about the fire services funding. I am just wondering if you would like to expand on those comments as you would have seen the fire services levy was a very inefficient tax in New South Wales, whether you would like to expand on that, give us some details about why you thought it was inefficient and whether you did go to look at alternatives.

Prof. WARREN — I looked at some of your submissions. You will see the fire service levy ranks pretty high. If you look at the IPART submissions, you will see the fire services levy ranks very high. It has its anomalies. Other states have addressed it — WA and Queensland. It really goes to a base issue, a tax-on-tax issue and a disincentive that arises as a result of the way the fire services levy is spread around insurance companies, individuals and local government. What exactly is a better mechanism of broadening the base? That is why we were looking at moving the fire services revenue and collecting it through local government, which is where the other states have gone.

There are some complications with doing that, because remember what you are trying to do is to protect the value of the property. You could say that unimproved value is not necessarily the value of the property, that the improved value is. That might be a better reflector. What happens is some property is not in the local government base but needs to be insured. You could say the base is not comprehensive enough. When you get to charities, there is an issue in hand there. But there was broad agreement that that issue needed to be addressed. There were some issues that needed to be addressed along the way, but it was not fundamental for other states and would not be envisaged to be fundamental for New South Wales.

The CHAIR — A number of us I think are very interested in your comments on the grants commission. If it is okay by others, I would be suggesting we spend a bit of time on that now. In the course of your evidence you mentioned that seven years is a very out-of-date concept. You mentioned five years and unweighted average; then you went to three years and you talked about the Canadian experience and the Austrian experience. I felt like you were trying to give us a shorthand version of what you think needs to happen. Here is your opportunity to give us as comprehensive a run-down on what you think should happen with the grants commission as you wish. Also, would you direct us to some particularly key research papers, journal articles or speeches that you think are iconic speeches or articles that are non-negotiable in terms of our reading for what we put on the grants commission in our report?

Prof. WARREN — Starting with the last one first, there are some brief comparative papers that will be useful for the review. They are Canada, Germany and Australia — and I did the Australian piece, so I can make those available to you. They are five pages, which makes it nice and accessible. What have the Canadians done? What have the Germans done? I can give you piles of stuff, including my own benchmarking review, but you are dealing with a couple of hundred pages. I think you need to cut to the chase, so I will start with that.

In terms of the way forward, I suppose what I do is reflect on what other jurisdictions have done. Probably one of the most researched federations is the Canadian system. It is constantly under review in a way that ours is not under review. They just completed their major review last year where they moved to quite a different system. What distinguishes Canada is (a) they do not have all the provinces in it and (b) they do not have the expenditure side in it; so they are just concentrating on taxes and then the specific provinces. They also identify particular taxes and particularly the resource-rich states. You will see there is a lot of debate in the 2010 review about infrastructure investment; how much should the state be able to retain; should the grants commission put all of it into the pool and redistribute it or only some of it? In the Canadian case, they say if you are a resource-rich state, you get to keep a certain proportion of your tax. It is stripped out of any equalisation that happens, because with that revenue comes a commitment to infrastructure. It is much more pragmatic. What we have got is an incredibly complicated system. The grants commission releases a thing called a simulator. It is most impressive for its

sophistication. The grants commission recognises that. In the 2010 review they are narrowing down. It is reducing its sophistication, but it is still an art; it is still a very sophisticated model. Do you need all of this sophistication? Do you need all the states? Do you need all the taxes? Do you need a framework this sophisticated and so demanding of data?

The CHAIR — Basically, is it useful for its purpose?

Prof. WARREN — I suppose you need to preface all of this by saying that everybody agrees that HFE needs to be addressed. Nobody is ever saying that you need to address the Northern Territory, Tasmanian and South Australian situations in terms of their access to tax base. The question is, do you put absolutely everything into the equation — all expenditure in all its detail and all revenue in all its detail? You will remember the old health-care grants. What would happen is the states would negotiate with the Commonwealth on those health-care grants. What the grants commission would do is work out the pool that the Commonwealth wanted. It had to allocate, but it would take off that pool the health-care grants. In a sense it was second-guessing that that allocation had been negotiated. It made it pointless to have a health-care arrangement because the grants commission's formula, putting that all into the equation, would just washout.

This is why it is absolutely critical with this Henry review, that if they are going to talk about revenue sharing and base sharing, where is the grants commission? You must review what it does, because there is no point talking about new federalism if the grants commission is going to take away all the political planning of all the other states and then benefiting. No state will enter into that territory. You can by agreement quarantine things — in other words, they are taken out of the grants agreed; they are removed from the grants commission's deliberations. This is quarantining. Some expenditure can and some revenues can be quarantined.

The language is there and the base is there, but how do you actually have a discussion? It is like having a 2010 review undertaken by the grants commission. You need someone to stand back from it and to benefit from and learn from other jurisdictions. The other jurisdictions have the same problems. We need to learn how they went through, what they came to and why - and why we cannot do the same. It becomes a real impediment if the Henry review comes out and says, 'We are going to go to revenue sharing; we are going to go to the Commonwealth', and it says, 'We will allocate this revenue back on a source basis'. That is not very meaningful, because the grants commission will address that. It will distribute that accordingly unless it is quarantined out. That is a big issue.

Mr DAVIS — It is like rowing against the arrangement.

Prof. WARREN — Yes, it is, because we are so comprehensive. No other jurisdiction is so comprehensive in terms of the way it addresses HFE.

Mr DAVIS — On that comprehensive issue, in a sense I understand what you are saying. You quarantine things, and the resource-rich states now want some of their royalties and so forth quarantined. From their perspective I understand that. But from the New South Wales perspective or Victoria's perspective — and this is a non-party political comment — you would say these states have perhaps had higher revenue capacity for a long time and for 80 years have been fleeced. When the thing turns around, they say, 'Let's change it'. If you look at the long sweep, you would say there is an issue there.

Prof. WARREN — That is right. I suppose the issue here in all these things is the transition and how you get from where you are to where you are going. We are seeing that debate happen right now with the 2010 grants commission review, because there are some real winners and losers with what they are doing. Some of it goes to the size of the pool and the role of the Commonwealth at the same time and the ability to ensure that there are not any excessive winners or big losers, or any losers, in that period. This is one of the critical things. You have to work out where you want to go and then how you get there, because there are 1000 reasons that you can

find that will stumble you along the way, but you need to work clearly at where you want to go, identify those issues and address them.

Mr DAVIS — Let me float a couple of issues with you. Contra to your comprehensiveness, and saying that perhaps less comprehensive is better, it seems there are perhaps some things that ought to be included in the cost side of the equation for states that impact on Victoria in particular and probably New South Wales, too. Large cities have congestion issues which are not fully accounted for, it seems to me. Costs of migrant settlement do not seem to be accounted for fully in the grants commission examinations. There are other costs that might come from large cities.

Mr ATKINSON — Age of public infrastructure.

Mr DAVIS — Yes, age of public infrastructure; population.

Prof. WARREN — I suppose the answer to that question is: do you want that large pool of revenue that you are distributing to go through that sophisticated machinery, or do you want to carve — and this is what the Canadians have also done — certain things out into a different category. You put a certain number of things through the grants commission algorithm. But do you want to try to make it do everything? When it comes to cities, do you want to separate out the city issue?

Mr DAVIS — I agree with your point, but at the moment it seems from Victoria's perspective, and probably New South Wales's perspective, that we have got the worst of all worlds, where we have a complex scenario, but the things that might be advantageous to us are excluded.

Mr ATKINSON — Do you agree with that?

Prof. WARREN — I appreciate the point that you have made your investment, yours is old, others have got resource revenue and they can renew or build new, you have the disadvantage. I appreciate all those issues.

Mr DAVIS — But they do not account for that.

Prof. WARREN — What I am just worried about is if you take the principle of the argument to its nth degree, we have got exactly the complexity that we had.

Mr DAVIS — In fact another layer of complexity on top.

Prof. WARREN — We have another layer. You should see what sits underneath — health, for example, which is what I have been looking at. The question is: how sophisticated do you want this? Do you want a single mechanism to address these issues, or do you want to be able to take things off line and address them? We see the federal government is talking about being involved in the cities — a cities program. In a way it is that kind of principle. Now, how you action that —

Mr DAVIS — Because they have had a lot of experience in Canberra.

The CHAIR — We are asking people: based upon all their experience, if they were redesigning X, Y or Z, what would they put in? If, arguably, you had the great opportunity of working on what should happen out of the grants commission allocation system — have you done a paper or a lecture on that? For example, in the ideal world, if Professor Neil Warren reigned over the grants commission future, this is your grand picture.

Prof. WARREN — The answer to that is it is work in progress. What I have been doing is a lot of backgrounding to it and understanding it. Words are easy, and they are cheap, and in the end they can be discredited and people can walk away from the argument. My view is that you need to do your homework, and you need to understand it. You also need to understand what other jurisdictions are doing so that it is informed and that what you are doing is not going out on your

own. I therefore feel it is best to address these things from the inside out. I have come to the view, having worked through this thing quite a bit now — and there is a group of us at New South Wales University who have got ARC funding; we are expanding that — it is not something — —

The CHAIR — So are we at a point where there are some tentative suggestions?

Prof. WARREN — Some of the things that I am working on now are really about how states can take advantage of the algorithm — how it impacts on reforms. In terms of where it can potentially go, I have some basic thinking about that. It is more towards where the Canadians have gone, that you should not have it trying to do everything; you are asking far too much of it. You became your own victim of that a minute ago.

Mr DAVIS — No, that is why I am talking it through, because I see the issues. My point is where we are now is historical more than anything else. There are a whole heap of things there that the larger states ought to have in if they are going to continue with that mode, or they ought to be dealt with somewhere else.

Prof. WARREN — My feeling increasingly is that they should be dealt with somewhere else. Just like not all taxes should be in there, you should not try to do all things. The perfect demonstration of that was when everybody knew that there were problems with the formula and we went and picked up the GST in 2000.

Mr DAVIS — But kept it with the same formula.

Prof. WARREN — We kept the same formula. Every problem they had doubled, because you had doubled the pool. That should have rung alarm bells. The Commonwealth said, ‘We will make sure nobody is a loser in that scenario’. That does not really address the problem. If we are going to go marching down the path of significant state tax reform, then for goodness sake — —

Mr DAVIS — It cannot be undermined, on the other hand, by the grants commission’s formula.

Prof. WARREN — At the present moment I have done some early work across a couple of state taxes. It extends across to expenditure as well, so it is not just a state tax issue. That needs to be much more informed about what is happening.

The CHAIR — Professor Warren, we have run out of time. If anyone on the research team has a follow-up item from your evidence, would it be okay if they emailed you and sought some further clarification?

Prof. WARREN — Yes.

The CHAIR — Thank you very much. You will be receiving a copy of the transcript in about a fortnight. You are free to correct typographical errors but not the substance of your submission.

Mr DAVIS — Can I just echo that. Thank you; it has been very informative.

Witness withdrew.