



**Australian Government**  
**Productivity Commission**

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**PRODUCTIVITY COMMISSION**

**INQUIRY INTO HORIZONTAL FISCAL EQUALISATION**

**MS K CHESTER, Deputy Chair**  
**MR J COPPEL, Commissioner**

**TRANSCRIPT OF PROCEEDINGS**

**AT 530 COLLINS STREET, MELBOURNE**  
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5 **MS CHESTER:** Good morning, everyone, and welcome to the public hearings for the Productivity Commission's Inquiry into Horizontal Fiscal Equalisation. My name is Karen Chester. I'm the Deputy Chair and one of the Commissioners on this inquiry and I'm joined by my fellow Commissioner on this inquiry, Jonathan Coppel.

10 I'd just like to begin the opening of these hearings by acknowledging the traditional custodians of the land on which we meet today, the Wurundjeri people of the Kulin Nation, and I would like to pay my respects to elders, past and present.

15 This is the third day of public hearings for this inquiry. We had two days in Perth at the start of this week and in coming weeks, we will also hold hearings in Adelaide, Darwin and Hobart. We will then be working towards completing a final report, which will be submitted to the Australian Government sometime early next year.

20 Before I just get into how we conduct our hearings, I am obliged by OHS legislation to say if alarms do sound, common sense should prevail. Don't use the lifts. Head to the green exit stairwells and follow someone wearing an unfortunate fire warden's hat and they will get you down the stairwell and take you down the road to Enterprize Park. I've done what I'm obliged to do.

25 Turning to the conduct of our hearings, I guess the purpose of our hearings are really to allow public scrutiny and feedback on the Commission's draft report and our workings, but also to allow public scrutiny feedback on submissions and commentary from other inquiry participants.

30 We like to conduct all our hearings in a reasonably informal manner, but a full transcript is being taken and thus we cannot entertain comments from the floor. At the end of the day's proceedings, we will provide an opportunity for anyone who wishes to do so to make a brief presentation.

35 Participants are invited to make short opening remarks. The debating bell will be rung at five minutes or so and the reason being that it does allow us then to actually have a frank exchange and to discuss the views of participants. Participants are not required to take an oath. All we actually ask is that they are truthful in their remarks. You are more than welcome to comment on the submissions and commentary of other participants to this inquiry. We encourage you to do so.

40 The transcripts from today's hearings will be made available from the Commission's website following the hearings, along with submissions to the inquiry that are already available on the website. For any media folk, and I

think there might be one or two in the audience, you should know the general rules that apply. If not, please gently head-high tackle one of our staff and they'll share them with you. Most importantly, there's no video or audio recording of participants for broadcasting purposes from hereon in.

5

We can now move to welcoming this morning's first participants, the Treasurer of Victoria and representatives from the Victorian Government. Thank you very much for joining us and thank you also for your pre-draft report submission and the wonderful meetings that we've had with your representatives, Treasurer, and staff from the Treasury, but also for being able to get a post-draft report submission in to us in such a prompt manner which helps us today. If you'd like to each just state your name and where you're from for the purposes of the transcript recording, and then if you'd like to make some opening remarks.

15

**MR PALLAS:** Thanks very much, Deputy Chair, and other Commission members. I'd like to introduce myself. I'm Tim Pallas, I'm the Treasurer of Victoria.

20

**MR MARTINE:** David Martine, Secretary of the Department of Treasury and Finance.

**MS AUSTER:** Amy Auster, Deputy Secretary, Department of Treasury and Finance.

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**MR PALLAS:** Thanks very much for the opportunity to present today and can I say that this will, of course, complement the initial submission to the Commission that the Victorian Government's made and also our response to the draft report. Both our submission and the response can be found on the Commission's website.

30

If I could go to the second page and the first slide, Victoria continues to be a donor. We consistently receive below our per capita share of Commonwealth State payments. We're the only state in the history of the Federation to have subsidised the Federation in every year since 1901.

35

Since Federation, that has meant that Victoria has received some 86 billion dollars less in total Commonwealth payments in 2016 dollars, than if the Commonwealth funds were distributed on an equal per capita basis, as shown in the chart. Much of that lopsided distribution of funds has been justified, based on need to address inequity between the larger States, such as New South Wales, and Victoria and smaller developing States.

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On slide 3, we strongly support the principle of horizontal fiscal equalisation, and you might not hear that from all the States that you appear before. HFE aims to provide State Governments across Australia with the

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capacity to provide a consistent standard of government services with the same revenue raising effort.

5 Victoria acknowledges that some States incur greater than average costs in delivering certain services for sections of the population. Also, some States have greater capacity to raise revenue, compared to the average of all States. It's an important principle of HFE that these differences are recognised and taken into account. Crucially, HFE does not impose particular policy choices on States and each of them is free to make choices about how it raises revenue and its expenditure priorities.

15 This is in keeping with the desirability of State Governments being accountable to their own constituencies, rather than to some external body or mechanism. The draft report found that the equity objectives of the current system is important and should continue being the basis for GST distribution.

20 On page 4, as the State whose budget is most exposed to royalty revenue, Western Australia's fiscal position is closely linked to the fortunes of the resources sector. As a by-product of CGC processes of using lag data to escalate GST relativities. That means that the States exposed to the resources sector are at risk of decreasing royalty revenue coinciding with declining GST payments.

25 The effect of the mining boom on Western Australia's GST distribution was predictable and it was incumbent on the Western Australian Liberal Government of the day to manage its finances accordingly. The PC notes in their draft report that the Western Australian budget of 2011-12, predicted falling GST revenues in the years ahead.

30 On slide 5, the fact that Western Australia receives a lower share of GST reflects its general capacity to raise its own revenue. In 15-16, Western Australia raised \$5,173 per head of population, significantly more than any other State. By comparison, Victoria raised \$3,271 per head of population.

35 The next graph on page 6 shows that when Commonwealth grants are added to State taxes and royalties, Victoria is the lowest ranked per head of population, while Western Australia is the second highest. In 15-16, Victoria's grants plus State taxes and royalties were \$7,184 per head of population, compared to Western Australia on \$8,302.

40 As we can see on slide 7, in Victoria's initial submission, we've adopted a principle-based approach on HFE, rejecting the self-serving advocacy that has plagued much of the debate in this area. When viewed through an objective lens, Victoria cannot accept the PC's proposal to raise weaker States to the average or some alternative reasonable standard.

45

The approach would be arbitrary. It would be designed to address the point in time fiscal concerns of one particular State and it would undermine the equity objectives of HFE. It does little to improve the transparency, simplicity, economic efficiency, or equity of the current system.

5

The PC's proposal to raise fiscally weaker States to the average fiscal capacity would see a shift in GST revenue from the eastern States to the west. The PC draft report estimates that its proposal would see Victoria lose \$972 million in 17-18, while Western Australia gained \$3.6 billion.

10

The GST on slide 8 forms a critical part of Victoria's budget. If GST revenue were to fall, the Government would need to respond by reducing services or increasing borrowing. The average fiscal capacity proposal highlighted in the PC's draft report, would see a reduction in GST payments to Victoria of \$972 million a year.

15

A GST hit of about \$972 million a year isn't an accounting change or a minor technical adjustment, it would have a major impact on this State's ability to deliver services for Victorians relying upon them. So, it's the equivalent of approximately 9300 teachers, 8700 nurses, 7700 police officers, or purchasing more than 100 E-class trams or more than 150 velocity train carriages.

20

In addition to the scenario on page 9 of raising taxes to the average fiscal capacity, the PC represents a number of other alternatives to calculate the GST distribution. One of those approaches is to raise States to the fiscal capacity of the second strongest State. Under this method, Victoria would lose \$4.4 billion over the past five years, compared to the current method.

25

Victoria is already being short changed on infrastructure payments from the Commonwealth and GST payments for our growing population. We are 25 per cent of the population, yet we receive 10 per cent of Commonwealth infrastructure funding. The last census showed that ABS significantly underestimated Victoria's population over the five years to June 2016, while overestimating the population in Western Australia.

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As the GST distribution method includes population shares, we estimate that Victoria received \$420 million less in GST than intended over the five-year period 2011-12 to 2015-16. Our population continues to rise rapidly at 2.4 per cent a year, and all these factors place pressure on the Victorian budget and they further highlight why our GST shouldn't be cut.

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On page 11, the inquiry has looked on whether or not HFE formula may act as a disincentive for a State to develop an industry such as mining, or to raise the royalty rate. We consider CGC current criteria to determine treatment of mineral resources is appropriate. The PC findings are consistent with Victoria's submission. The PC report found that there is no direct evidence

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that GST effects have influenced State policy decision making in relation to minerals and energy.

5 The report also notes that adding incentives for resource exploration policies would be an intentional breach of police neutrality in State autonomy, be a source of additional complexity, and at the expense of equity. States must be allowed to weigh up the broader social, economic and environmental effects of fracking, without Commonwealth interference. Victoria must not be punished for putting our farmers first and protecting their world-class produce  
10 in our environment.

The current GST distribution system doesn't deter States from implementing tax reform. Weakening HFE would act as a disincentive for States to manage their budgets appropriately, as States could expect additional  
15 GST revenue to fix the shortfall.

In conclusion, Victoria continues to support the principles of HFE. We accept that it is reasonable for a large, strong State such as Victoria to continue contribute to States with high needs and low revenue raising capacity. As our  
20 formal submission outlines, we also have a number of concerns with the Commission's methodology.

Fundamentally, Victoria does not agree with the PC's alternative proposals, as they represent a total departure from HFE for the benefit of one  
25 State, and the Andrews Government will not accept any proposal that would reduce our capacity to deliver the services that Victorians rely upon.

Thanks very much for the opportunity to address you.

30 **MS CHESTER:** Thank you, Treasurer, and thank you for managing to canter through your slide pack so promptly which allows us more time now to chat. Just for the benefit of the transcript and for those joining us this morning, the Treasurer has provided us with a slide pack which we will take as an addendum to your post-draft report submission, and that will be available on our website  
35 as soon as possible.

Let's open up with some questions then, and perhaps if we rewind the clock a little bit first to better understand how this inquiry came about. As I think I touched on, Treasurer, when we met and spoke at the CFFR meeting in  
40 Sydney, the sort of overarching theme of our report is that the HFE system now seems to be a world of outliers and there were three in particular that we identified, the first being the way Australia does HFE. We do punch above our weight globally and we said on the whole that's a good thing, and indeed we do support the equity and equality principles underpinning HFE.  
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The second outlier which is also how we deal with indigeneity and that's one that we sort of grappled with probably a little awkwardly in the report.

5           The third one is the more recent outlier, being the royalties of Western Australia. I think, taken together and where the relativity band has gone, particularly in the last five to six years, we felt that the system was having difficulties grappling with that, not just in terms of public accountability and the pub test in the west, but more importantly, what impact that might have on incentives for States and impact on the real economy.

10           In that regard though, I guess one of the questions that we posed in our draft report was to what extent is the outlier of WA here to stay for the foreseeable future. To what extent is this a blip, or is this the new norm, because that in itself would inform our thinking around what changes might be needed.

15           Treasurer, I think you did touch on it a little bit in your post-draft report submission to us, but good to get your sense of whether you think WA being the fiscally stronger State is here to stay for the foreseeable future.

20           **MR PALLAS:** I suppose if you look at graphs 5 and 6, they sort of tell a story that I think demonstrates that the system works, even in the circumstances that we currently confront. As you can see, despite the reductions in commodity prices in 15-16, what we are seeing and what has, I think, held through to present day, is that there is a continuing capacity for the State of Western Australia to raise own source revenue, and that includes, of course, royalties.  
25           Even in circumstances where the commodity prices have reduced, Western Australia's revenue raising capacity is still greater than any other State.

30           Graph 6 to me really demonstrates the worth of preserving the principles of horizontal fiscal equalisation. Victoria could feel aggrieved as a State in the context of slide 6 to say if you looked at State taxes and royalty revenue and Commonwealth grants per capita, we are the lowest State in terms of receipts. I didn't have Northern Territory on this chart because it would distort the chart dramatically, so I apologise for that.

35           What this shows us is the States, all of the States, are in a band of \$8500, let's call it, per capita in '15-16 and Victoria the downside outlier is in that \$7000 plus per capita. The proposition I would put is what problem are we trying to fix here. Is it the capacity of the States to meet the embedded demand of their populations for budgets to be run efficiently?  
40

45           Certainly, the share that the States have, both in terms of their own revenue raising capacity, as I show on slide 5, even in circumstances with a downturn in commodity prices, are up against the offsetting impact of Commonwealth receipts per capita. What we can see is that the States are within an acceptable parameter band to ensure that they can provide the services that their communities require.



5 I don't think the first proposition I put is what's broken in the system, if you look at the receipts Western Australia are actually receiving per capita, are both in terms of their own revenue raising efforts, and that's taxes and royalties, or indeed the augmented per capita revenue coming in to that State through State and Federal provision.

10 **MS CHESTER:** I think we agree. Indeed, I think we're on the record in our draft report saying we don't see the system as being broken either. We just kind of see it struggling with the outlier, and the reason being that when you have such an outlier State, and it's not just the rubber band of the relativity stretching so far, it means the equalisation task within the GST pool itself becomes greater. And the more you move away from an EPC distribution, it's much more difficult to grapple with the trade off between equity and efficiency.

15 Just on the outlier point, I guess we did get evidence from WA earlier this week and not just from their Government but also from industry over there to suggest that the outlier story is probably here to stay for the foreseeable future, and thus we're faced with a situation of a large part of that GST pool will be a redistribution and thus it strays from EPC.

20 Why does that kind of matter? It comes to this trade-off between equity and efficiency in HFE. Treasurer, as you would know, there's more than one principle that the CGC tries to follow. HFE through equity, but also the trade-off with efficiency and I guess that's where we're grappling a little bit. How do you see the CGC in an outlier world dealing with that trade-off between equity and efficiency, when they themselves have moved the objective to full equalisation?

25 **MR PALLAS:** Well, I suppose one of the points I make is the greatest thing that will facilitate equity is to make sure the capacities for raising of revenue by States in their own respective jurisdictions is taken into account. For better or worse, Victoria does not have a capacity to mine the sort of – or to get the bounty of royalty revenue.

30 If you look back over the last 10 years, let's say, in terms of revenue that the State of Western Australia has got from royalties, in 2004-05, it picked up about a billion dollars in revenue. It reached a high in about '13-14 around about \$6 billion in revenue. That came off and by about '16-17, the numbers moving back up to that all-time high in terms of the royalty revenue.

35 It's true to say that they've gone from about a \$4 billion receipt in GST, where I think they peaked out in about '07-08 and they're coming back down now to a number more proximate to \$2 billion. But you need to look at that in the context of the great bounty that that State has received as a consequence of the royalties that they're picking up as well.

From my perspective, what is the greatest impost upon the efficient delivery of services is that there has to be predictability in terms of the revenue that's coming in. If you added together both State-based revenue and Commonwealth receipts, all of the States have a fair degree of confidence about what's coming on.

A large one-off hit by applying, let's say, one of the two options, a second-best horizontal fiscal equalisation methodology, if I could call it that, I think that system would massively disadvantage one State, in particular, the State of Victoria.

Most other States, as well, would be disadvantaged by it and Western Australia for a one off point in history would be massively advantaged. I'm not sure that that methodology would necessarily peter out over time, given that they could expect to continue to have a substantial windfall in terms of their royalty revenue going forward.

**MS CHESTER:** We might come back to metrics and the transition path a bit later. It's always fun when you're starting in a world of outliers and you've got a zero-sum game and a Federal Government that doesn't have too much money to help with transition paths.

I guess the two things that we're looking to focus on in our post-draft report stage are firstly the evidence base around the efficiency effects of the current way we're doing HFE. Then the second issue is if we do recommend moving to an alternative, what would be the best way of managing that from a transition path perspective.

Traditionally, people have focused on the efficiency effects of HFE in terms of the impact on interstate migration, and there we came to a landing that's not disparate from others that have traversed this path before as to say that it doesn't have a material effect.

The other thing we were focusing on and indeed our Terms of Reference asked us to, was what impact might HFE have on the incentives of State Governments to have in place good policies, and good policies in terms of their revenue bases and how they tax those revenue bases, and also in terms of decisions on development activities.

We understand your point earlier, Treasurer, that when a State Government makes these decisions, there's a multitude of factors on the Cabinet table and how it may impact the GST bucket may not be a primary consideration. It's just good to get your sense on that second stream of efficiency impacts in terms of development decisions and impact on tax revenue decisions.

5 **MR PALLAS:** I think just to restate briefly, Deputy Chair, my principal observation that we support the approach that's been adopted by the Commonwealth Grants Commission, reinforcing the need for policy neutrality. Ultimately, States have to be held accountable to their respective constituencies for the decisions that they make.

10 The other point that I would make before handing over to the Secretary of my Department is, from our perspective, it is important to recognise that the choices that Governments make are not so much exclusively related to the state of their budget, because we have not only a responsibility to run responsible budgets and deliver the expectations of the community in terms of services, but also, we have a direct impact upon the way that the economy operates.

15 We're effectively a substantial player in the performance of the Victorian economy. What choices we make in terms of tax mix will have a direct impact upon those issues. From my perspective, you look at the way the Victorian economy is operating at the moment, it has massively improved its performance over the last three years.

20 We now have, if you look at State final demand, in '16-17 we're almost running at twice the speed of the rest of the nation at 4.7 per cent. All of that, of course, underlines embedded obligations upon the State. We've got 2.4 per cent population growth. We have to accommodate those.

25 The point just principally that I would make is, firstly, States should have the sovereignty responsibility that's been provided to them in the Constitution that respected and, therefore, policy neutrality should be the issue that the States themselves determine and they are accountable to their respective constituencies for the choices they make.

30 Secondly, I would say you need to recognise that every State makes a choice about the state of their budget, but also recognise their obligations in terms of the state of the State's economy, if I could put it that way.

35 **MS CHESTER:** Sorry, just before you hand the baton across to David, it would just be good to know, because this is an area where we've struggled to get evidence and I can understand why most State Governments are shy on this one, in your time as Treasurer and during Cabinet deliberations in any sort of policy matter, has the impact or the expected impact on GST relativities ever  
40 been a consideration in any of those discussions?

45 **MR PALLAS:** Well, I'm not allowed to talk about Cabinet deliberations, but I can tell you that it is very much front and centre of the Government's thinking, what the impact of GST projections will have upon our budget, particularly for the formulation, the bodies that assist in the formulation of the budget. We keep a close eye on where we see those projections going.

5 Of course, as I noted in '11-12, I think it was, the Western Australian budget identified that they could see a shortfall in GST revenue coming through. All the States, all the States keep a close eye on how the methodologies are being applied and how the economic data being fed into that will impact upon State receipts.

10 **MS CHESTER:** We're very well aware that the States do keep a close eye on these things and I should have probably said, apart from our work. I guess I was more getting to when the state is considering issues like changes to tax policy or development decisions, or any other sort of policy levers that you're pulling, do deliberations ever take into account what the impact is on GST relativities?

15 **MR PALLAS:** For the purposes of appreciating what it will do to total receipts, I think the answer honestly would be yes. But do we gain GST funding on the back of decisions that the State makes? Absolutely not, because it's relatively marginal those decisions, their impact on our budget position.

20 So, yes, we're cognisant of the impacts that might accrue from it, but they tend to, when they play out, be relatively marginal in terms of the benefit or the disincentive that the State might receive as a consequence of those decisions.

25 **MS CHESTER:** We'll try to get to a better understanding of why you think they're so marginal in a moment, because we've had the benefit of reading your post-draft report submission, but I'll shush up now and let David speak.

30 **MR MARTINE:** Thank you, Deputy Chair. I just wanted to make a few very brief comments. Firstly, just going back to the first part of the discussion around Western Australian being an outlier, we actually don't see Western Australia as an outlier at all. Our view would be that that's HFE actually working. There's a very good reason why they're getting a very low relativity and, as the Treasurer indicated, it's because they're getting quite high royalties.

35 Now, whether that's temporary or long term, in our view it doesn't really matter. They're not really an outlier, it's HFE at work. If they continue to get a very high level of own source revenue, including royalties, then for HFE to actually work properly, you would expect them to have a low level of GST going forward.

40 Our view is we don't think the real issue is whether it's sort of long term or short term, or whether they're an outlier. You would have noticed there was a bit of those issues being picked up in other papers.

45 That's the first point. The second one - - -

**MS CHESTER:** But you would agree, David, that having such a – sorry, for us I guess the outlier is we’ve never had a State be that fiscally disparate from other States in terms of revenue raising capacity in the history of Federation, and that changes the composition of how the GST pool is distributed.

5

**MR MARTINE:** Yes, it certainly means that more of the pool gets distributed than if they were at a much higher relativity, no question about that. The redistribution system has been in place for quite a while. There are some things at the margin that we and most jurisdictions have raised with the CGC from time to time when they do their methodology review, but fundamentally, the distribution system does work well. We don’t see the WA situation as an outlier in that context.

10

Just on the question of the impact of HFE and efficiency effects. There’s a little section, which I won’t go into in detail, in the Government’s report, but we certainly agree with the inclusion of the PC that there isn’t really much evidence out there that HFE has been adversely impacting on productivity or economic growth across the economy, so we agree with that conclusion. Just on the question of - - -

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20

**MS CHESTER:** Sorry, just so we’re not mischaracterised, to the extent that there are disincentives for tax reform by the larger States - - -

**MR MARTINE:** I was just going to come to that.

25

**MS CHESTER:** Okay, good.

**MR MARTINE:** I mean certainly when bureaucracies, and I’ve had these discussions with my colleagues around the country and the States, if we’re developing some policy options, whether it’s tax or other areas of Government policy, and we’re developing the costings, we don’t – and no jurisdiction does this either – present sort of costings to Government saying, “Here’s a tax reform on this part of the tax system and embedded in the costing is some sort of GST effect”.

30

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As the Treasurer indicated, most of those when you’re talking about individual tax measures are very, very marginal. I mean you’d have to be thinking about some major significant rethink of a whole jurisdiction’s tax system before you would start thinking about what does this do to the GST.

40

So, for most jurisdictions, when you’re developing in the bureaucracy tax measures to propose to Government, you don’t take into account the GST impact of that particular measure because it’s just too insignificant.

**MS CHESTER:** I guess that’s why we sort of developed some cameos around more significant revenue reform and we chose one in particular, because most economists will agree that that’s a good change to a tax mix.

45

5 That was what started us down the path. Indeed, we went and asked States  
and Territories for examples of cameos themselves, and we did get some  
evidence from other States. I think where we sort of found a large disincentive  
for New South Wales or Victoria from daring greatly and doing a revenue  
neutral switch between stamp duty and land tax, we found that having a more  
than immaterial impact on GST. Indeed, we ought to bank between \$700  
million and \$1 million each year. I think you've suggested in your post-draft  
report submission that those numbers aren't right, that you see it being  
10 immaterial?

**MR MARTINE:** Yes. I'm just finding the right reference. I think it's in  
section 3, page 19, I think it is. I guess coming back to my earlier comments,  
the concern or the issue that we raised in our draft report is – sorry, in our  
15 response to the PC's draft report, is that's not the way that jurisdictions cost  
tax measures.

The PC's analysis that came up with the numbers, I think we talked about  
it at CFFR, makes a whole range of assumptions on elasticities. It's always a  
20 problematic area, as you'd no doubt be aware, in terms of costing, tax measures  
and tax reform, because you can get into a bizarre world where you could  
propose a reduction in tax and have it raise revenue.

That's that question of to what extent does the second, third, fourth order  
25 effects come into play. So, you cut taxes and the argument might be that it  
promotes growth and people are spending more and there's more company tax.  
Jurisdictions don't cost tax proposals that way at all. Once again, we would  
not see even what I describe as a semi-substantial tax reform, such as a stamp  
duty or land tax switch, as that decision being impacted at all by people  
30 thinking of what it might do to GST.

I didn't sit in on the ACT discussions obviously, but they've obviously  
gone down this path. I'd be surprised if they sat there thinking, "What does  
this mean for GST?" I think even the semi-major reforms - - -  
35

**MS CHESTER:** I think in our report we make it clear that it's more an issue  
for the larger States and it is a first move of disadvantage. So, I wouldn't be  
surprised, having spoken with the ACT Government about it, and indeed on  
the public record they've said that (1) they don't have modelling capabilities,  
40 and (2) they're such a small jurisdiction that it wouldn't have been as material  
as it is. It's really for the larger States that we are concerned.

**MR MARTINE:** I think on page 19 we re-costed that scenario on how we  
would normally cost those sorts of measures and present it to Governments to  
show the point that what we would be presenting is actually quite a minimal  
45 impact on GST. In other words, it wouldn't be part of the consideration or

advice from the Treasury of the jurisdiction to say, “If you did this, there’d be a significant impact on GST”.

5       **MR COPPEL:** This is a really quite substantial change to the structure of taxation, reducing stamp duties by a factor, or by half, and replacing them with land tax. Can you really justify why you would expect to make those calculations on the basis of zero elasticity?

10       **MR PALLAS:** If I could just jump in while we get a much better economic response from the Secretary. We’ve already started a process of removing stamp duty. For example, we’ve taken the stamp duty off first home buyers acquisitions, up to \$600,000, and progressively will introduce up to \$750,000.

15       Putting aside the fact that we offset that with alternative taxing arrangements, that’s an \$850 million over four-year hit to the budget. If you walk down Collins Street and you bump into an economist, they’ll tell you, even my Treasury tells me that a tax on transactions impedes economic activity.

20       Of course, governments have to not only manage budget and budget inflows and outflows of revenue, but we also have to be cognisant of where the community’s appetite for taxation resides. In many respects, I think the idea of the modest reduction of burden on transactions is a good thing. Where we can and when we have budget capacity, we proceed down that route.

25       We also have to be very much focused on exactly where the community’s appetite is prepared to go. Whilst the economists on Collins Street, or wherever else, might tell us that removing those transactions is a good thing, when you tell them the flipside of the equation and that is the family home would ultimately have to have a tax burden attached to it year on year, I think that certainly in the population at large the appetite for that would very quickly dissipate.

30       **MS CHESTER:** That’s why our concern is so great here, Treasurer, because we know it’s a political battle to dare greatly and do these good reforms and yet the calculations that we did, including looking at different elasticity effects with confidence bands, that’s why we’ve got such a broad range, why would you bother if you’re also going to feel the pain of a GST bill.

40       **MR MARTINE:** Just coming back to that particular point, we don’t really see it as a key part of the HFE issue. I mean it’s an interesting scenario. It’s an interesting discussion. We could probably sit here all day talking about the Laffer Curve and elasticities, et cetera, but I don’t think the scenarios, even if you accept the proposition that we should be taking into account elasticities, supports in any way the draft recommendations about, in a sense, going to the  
45       second or the average.

5 In a way, that sort of argument would support a logical conclusion of going to per capita, because effectively what that scenario is saying is that HFE has some impact on – the distribution effect has some impact on how you think about policy. The natural conclusion would be the only way to remove that is a pure per capita system.

10 In a sense the scenario, whether you include elasticities or don't, and the point we're just making in our paper is jurisdictions don't take into account elasticities when you're costing tax measures. I can only probably think of one in my time in the Commonwealth, which was a very significant tax reform, that they included some of those effects.

15 Even if you do that, it doesn't really support the conclusions of the report, which is we therefore should extract out Western Australia essentially from HFE because that's the effect of going to the second strongest State. In a way, we sort of see it as an interesting conceptual discussion. We can debate it for some time, but I don't think it's front and centre for the issues at hand, which is whether HFE is working or we should go to the recommendation that the PC has come up with.

20 **MR COPPEL:** We're not suggesting that the proposals that are in the draft report would remove that in principle, disincentive. Really what we're getting at, and that's fundamental to the draft report, is a balance between some of the objectives that are being sought through the HFE.

25 We've certainly got the equity of equalisation objectives, to the extent that there are these disincentives at the margin to State policy, which may have implications then for efficiency. Can we give some weight to those? It's a balancing or trade-off to some of those objectives, which I guess brings me to the point about all of this discussion takes as a given that we've reached a state of full equalisation.

30 The CGC for about 40 per cent of revenues is on an EPC basis. Full equalisation is an aspirational goal. It's not always possible because there's limitations in data or there are effects that can't be sufficiently accurately measured, so they may be decided on an EPC basis, of there may be discounting.

35 When you look at it through that perspective and compare it with what we're proposing and we've got a number of examples that sort of illustrate what the changes would be, they're actually quite small across most jurisdictions. That is looking at it from the perspective of today. They would be even smaller when we start to think about transition paths or implementation phasing.

45



I'm wondering whether, when you make comments like what we're recommending is a total departure from HFE, given that explanation, how can you justify such a comment?

5     **MR MARTINE:** Just a couple of points on that. We, as you would have  
picked up in the Government submission, we wouldn't see the draft  
recommendations of the PC as just tinkering at the margin. As the Treasurer  
indicated, depending on whether it was second strongest or average, it would  
nearly a billion-dollar reduction in GST revenue per annum, based on the PC's  
10     figure. So, it is a significant recommendation. The reason why - - -

15     **MS CHESTER:** That's only if we rewind the clock and unfortunately, we  
don't have the TARDIS. I guess maybe we should jump to transition path and  
we'll come back some more to the world of trade-offs because it is a very  
difficult one.

20     Actually, before we do and it's interesting, I think you sort of hint at it in  
your post-draft report submission, and it became a little clearer in the CGC's  
post-draft report submission to us, which I'm not sure if you've had a chance  
to look at, but it makes the point – it makes it very clear that it's not really  
around this whole issue, Treasurer, whether or not States have the fiscal  
capacity to meet their assessed expenses under the CGC's calculations.

25     But it's really VFI, vertical fiscal imbalance, that's the driver here because  
we know that even Western Australia, under the current arrangements, cannot  
meet its assessed expenses. When we equalise to the highest State, it still  
requires that third step in our little simple diagram of then doing the final  
redistribution on an EPC basis. Really, it's vertical fiscal imbalance that's  
driving the issue of State's fiscal capacity to meet their assessed expenses.

30     **MR PALLAS:** Well, talking about it to others, I think I could probably - more  
for Australia on the inappropriate nature of the way our tax system is  
structured, the disparity between the delivery of services and the capacity to  
raise revenue as between the Commonwealth and the States. That's absolutely  
35     the case and, of course, that situation progressively became apparent early in  
the years of Federation, but most notably with the Commonwealth using its  
defence powers to apply the income tax responsibilities from the States and  
never returning them.

40     History is history and we deal with the circumstances that we're in, but we  
are seeing this ever-increasing abrogation of Commonwealth responsibilities  
to the States in terms of service delivery, but in inadequacy, as it were, of  
Commonwealth receipts coming in to the States to make up that shortfall.

45     I definitely accept that VFI is a very substantial issue. For the purposes of  
the discussions we're having today, it's really around the GST and its

contribution to horizontal and fiscal equalisation. I suppose the proposition is, what is the problem we're trying to fix here.

5 We've got a situation where one State is currently an outlier in terms of the aggrievance that they see. I think we've been able to demonstrate on per capita terms their revenue capacities are relatively strong by comparison to other States, whether it's in their own right or whether it's augmented by Commonwealth receipts.

10 The proposition I put to you, if you say that some States are having difficulty matching their ability to deliver services, firstly, that's choices that they have to make and on the principle of policy neutrality, I won't get involved in an argument about whether or not any particular State has managed those responsibilities well or poorly. All I'll say is that's their choice and they  
15 ultimately are held to account every three or four years for those choices that they make.

I do make the point that if you look at Western Australia and you look at the receipts that they have and will continue to get as a consequence of a  
20 proposition that's being proposed, particularly on the royalty side, they would have a massive windfall if, for example, we were to go through another mining boom and you had this commodity price spike come through on a second-best HFE principle.

25 They would be allowed to keep that and it would be literally – I think we did a calculation – be in excess of \$3 billion per annum that they would see as the bounty and gift of the revised system and at a time when all States struggle with their delivery of services to the community, struggle with falling Commonwealth receipts.

30 No State falls or feels more aggrieved than that, particularly on the infrastructure side, than Victoria. The fastest growing population in the nation by quite some distance, but less than 10 per cent of national infrastructure allocations.

35 **MS CHESTER:** I guess the reason why I took the discussion there is even WA with its bounty, even they, when you do the first two steps of horizontal fiscal equalisation, when we take every State up to the fiscal capacity of WA, even then they cannot meet their assessed expenses. It wasn't until I read the  
40 CGC's post-draft report submission to us that that became apparent.

We'll come back to it because I think your submissions intimate some thinking about longer term Federal financial reforms that are quite - - -

45 **MR PALLAS:** Just on that point, I mean every budget that I produce I give an illustration of what our expenses growth is and what our revenue growth is. Over the term, over the fiscal cycle, I make it a very clear fiscal parameter of

this State that we don't spend more than we earn and that could be hard. It means that you have to make choices, but that's the way that we choose to budget and we think that, ultimately, that is the responsible thing to do.

5       We also think that the electorate will recognise that economic responsibility is its own reward. Perhaps it's a political reward in the polls, but critically important, these are choices that every State makes, how they balance expenditure to revenue.

10       **MR MARTINE:** Just very quickly, if I could just follow on, Deputy Chair, to your comment and just as a reference, on page 12, figure 5 of the Government's submission where we've reworked "is equalised as proposed to the second strongest State", what you do see there is Western Australia's own source revenue, plus the GST requirement, therefore sits above the assessed expenditure.

15       **MS CHESTER:** Yes.

20       **MR MARTINE:** In other words, we look at that and we would say that doesn't look like HFE because, in this case, one State is receiving more money than they need to meet their assessed expenditure, and most other States are then worse off. So, we wouldn't see that as HFE.

25       **MS CHESTER:** Only HFE when it's equalising to the same standard, which means that that bar needs to be the same across, whereas historically the CGC didn't equalise on that basis. It was only more recently that they've moved to the same standard.

30       History actually reveals quite a lot in this area. We couldn't find any Government, Federal or State, that had ever sort of signed up for this form of HFE. Indeed, I think the CGC started doing it that way in 1981 but weren't on the public record as having done it that way until just prior to signing up to the GST deal.

35       But then when Victoria signed up to the GST deal, your predecessor, Treasurer Brumby, said we're not signing up with the way that they're doing HFE at the moment because we want to move to EPC. I think we need to be careful not to characterise HFE as a single way of doing it.

40       The adjective before standard has changed, only recently at the CGC's whim, not at a decision by any Commonwealth, State or Territory Government. **MR MARTINE:** But it is the current system. Our counterfactual at the moment is that is the current system.

45       **MS CHESTER:** No, I can understand that because that's the starting point at the moment. If we take that starting point, and given some of the comments, David, that you made earlier about sort of the picture you're looking to paint

about Armageddon for Victoria under moving away from equalising to the average or equalising to the second highest, by just going from same standard to reasonable standard, when you kind of look at that in the context of the Victorian budget, it would only result in about a 1.2 to 2 percentage point reduction in your GST as a percentage of State total revenue.

Then when you look at sort of what changes you've had in GST relativities historically, it's kind of within that bandwidth of change. Then if you actually have a look then at the difference between assessed expenses and actual expenses by the Victorian Government, it wouldn't really make any difference to what you actually spend on assessed expenses, if that makes sense.

I'm suggesting that the changes that we're recommending aren't really an Armageddon. Indeed, the Victorian Government would still be able to, given your current track record of what you actually spend on the assessed expenses, the actuals versus the assessed, there wouldn't necessarily be any less services for the Victorian people.

I'm just trying to do it in term of the contextuels. You mentioned a billion and that sounds like a big number to people, but when you take it into account with the total budget and then what you're actually spending it on at the moment, it's kind of not an Armageddon.

**MR MARTINE:** Well, nearly a billion out of total revenue for the state of a bit over \$60 billion is pretty significant. So, if we did it based on the PC's own calculations, which we've checked, it is in the 900s that we would lose annually. Now, that is a significant number. Yes, we do receive revenues in total of about 60 but, as the Treasurer indicated, \$972 million can actually achieve a lot of service delivery here in Victoria, so it's not an insignificant amount.

**MS CHESTER:** I guess it's coming back to the point, because I'm just conscious that this will inform the debate, the numbers and the suggestions, if it's going to cost this many teachers' jobs and these many police force, that when you look at it contextually and when you also look at what you've spent over time, indeed, over the past six years you've never actually spent your full assessed expenses.

**MR PALLAS:** That is, we haven't actually run a deficit.

**MS CHESTER:** Well, no, you've got the money to do it. You've gotten that money from the Commonwealth Government but you haven't spent that. You haven't reached your assessed expenses. You've actually been under it for the last six years.

**MR PALLAS:** We've managed them responsibly. One of the worrying elements of this conversation, I think, goes to the idea that a financial

responsibility isn't an assessable goal, as it were in this process. If you look at the longstanding view of the Commonwealth Grants Commission around policy neutrality, it essentially says that governments make whatever decision they make. They are, after all, sub-sovereign jurisdictions who have constituencies that they have to answer to.

The Federal Treasurer who introduced the GST, to which we're arguing about the disbursement of, made it very clear that in his view that the GST was a States tax. In fact, he had a long-running argument with the Auditor-General who qualified Commonwealth accounts as a consequence of that dispute.

The point I make here is if you're effectively saying that States that don't concern themselves with the comparability between receipts and expenditure, who wait upon the bounty of international circumstances and the stuff that they dig out of the ground to provide the capacity for them to manage their budgets, well that's their choice.

I'm not being critical of them. I would just manage things differently and I would run my economy and the way my public-sector expenditure was going considerably differently, but they've chosen not to, and they should not be rewarded for it.

**MS CHESTER:** I think our draft report has a pretty frank and fair exposition of that. I only raise those points because people talk big numbers and translate them to jobs.

**MR MARTINE:** Sorry, Deputy, just quickly, just on that point. I think it's important though that the Commission thinks about the impact of its draft recommendations on State budgets, what would actually happen and how would Governments respond.

If we did go down the path of second strongest or average, it would be a matter of fact, based on the PC's calculations that the State of Victoria would lose revenue coming in to our budget in the 900 millions, so just under a billion dollars. Then it would be a matter for Government to choose how to take that into account

It can either, as the Treasurer indicated, cut spending on services and the Treasurer gave some metrics on what that might mean on health and education, or you're letting your budget go into potentially deficit, et cetera. Those choices would need to be made. But it is actually a real reduction in revenue coming in to the State.

**MS CHESTER:** No, no, and that's a perfect segues to transition path, David, so thank you for that perfect segues. We are very mindful and nor would we ever suggest, and we say that in our draft report, that we would never

recommend Government do a sort of an overnight cold turkey and move to ETA or equalising to the second highest.

5        Indeed, when you look further down the transition path and WA, I don't know if you've had a chance to look at their post-draft report submission, but they've suggested a transition path that would sort of – and this is their longer transition path which they think is their generous transition path. It takes you out to 2026-27, so a nine-year period to help States with the transition and budget management, as you rightly point out, David.

10       That would only see Victoria actually as a net winner during that transition path period. There would be no impact on the Victorian Government for the first three years, just over 30 million for the next two years and then you're up above hundreds of millions positive beyond.

15       That's why we do want to focus on transition path in this stage of our consultation and just get your thoughts on what would be some guiding principles. We only touched on one in our draft report and that being making sure that the smaller States weren't materially disadvantaged. I note and would want to take into account any immediate budget effects.

20       This sort of transition path that WA has suggested, and it would be good to get your feedback on it, would address the concerns that you've raised with large number of 4.4 billion and one billion and the like. What would be the guiding principles that you'd want us to try to take into account if we are to craft a transition path for the Government in our final report?

25       **MR PALLAS:** The first proposition I put to you is we're not interested in a transition path. I think we've given you a pretty compelling case that the HFE principles underpinning GST actually achieve their stated objectives. There is no discernible reason in merit why the State of Western Australia should be given the sort of bounty that's been proposed here.

30       For them to propose a transition path to that bounty, I think just leads to the obvious conclusion that whatever – and I will be judgmental here on Western Australia – whatever bad choices the Liberal Government made in that State for many years, the size of their bureaucracy, the choices that they make in respect of where State gets involved in the delivery of services, there has been no imperative for them to make change and that is a decision that those Governments have had to live with.

35       We've taken a different path as a State, through consistent Governments over a long period of time recognising that we have to make choices. The idea that the State should be subjected to the uncertainty and, might I say, the unwarranted intrusion of a path towards a transition to a bounty for the State of Western Australia, is something we would oppose. We oppose it simply

because what's broke in their system, in terms of a fair dispersal of entitlement to each State.

5 We're probably one of the few States that makes a contribution to the Federation who comes here and says we support the principle of horizontal fiscal equalisation. We're not talking about per capita shares. Our position has, in a nuance sense, changed over the years. We recognise our responsibilities to the Federation, responsibilities we've complied with each and every year of Federation.

10

But to now suggest that the process that the Commission is heading down is that the State should contend itself with a transition to a system that we see as being suboptimal, and certainly worse than the existing arrangement, I would simply say to you we are not interested in such a distortion and such a gift of bounty to the State of Western Australia, a State that has made little effort to address its underlying economic and budgetary providence.

15

**MR MARTINE:** Sorry, Deputy Chair, if I could just add one important point about the transition. To actually come up with those numbers you've mentioned, we're talking sort of nine years out, no jurisdiction has any revenue or spending forecast beyond a couple of years.

20

**MS CHESTER:** I know and that's one of our biggest challenges, so we've asked WA for the underlying metrics. Indeed, we'd probably want to talk to State and Territory officials around those projections to see what sort of confidence we could attach to them, albeit we know it's very difficult. I guess intuitively we kind of know, given Victoria's starting point, that if you get three or four years out and you're getting closer to EPC, Victoria is a net winner here in a budgetary sense.

25

30

**MR MARTINE:** The problem is most projections, and all State and Commonwealth Treasuries do longer term projections, but they all do the same thing, which they assume we all go back to normal. So, if the projections are all assuming that we all go back to normal, then it's not surprising that Western Australia's proposal, they would argue has minimal impact on the other States because the underlying assumption is that we're back into a normal world.

35

**MS CHESTER:** No, and we did ask them that very point because that was our thought as well. We know everyone normally goes back to historical trend. We do have them on the record as saying that they are forecasting their bounty continues. We'll look closely at those numbers, but intuitively speaking, medium to longer term, and correct me if I'm wrong, Victoria would stand to benefit from moving away from equalising to the highest State in a fiscal sense.

40

**MR MARTINE:** I can't see how that would be the case.

45

**MS CHESTER:** Moving closer to EPC would always benefit WA, wouldn't it?

5 **MR MARTINE:** I'd need to sit down and – I don't quite understand the WA point, because I can't see how – whether you transition overnight or whether it takes nine years, to me the point is still the same, that Western Australia has a very significant own source revenue and royalties. So, unless, somehow, they're predicting that that's going to drop away substantially, then I can't see how we can end up at a substantially different end point to what we've got in the submission.

10 **MS CHESTER:** I think the starting date does matter a lot because of where we're starting at the moment with their relativities being so low. We know it takes three or four years for them to even get up to early 70s or late 60s. As you delay that starting point, the impact on other states like Victoria are less than the early years.

15 **MR MARTINE:** I guess the other point about transition is in 15 years, and let's say there's another mining boom and WA's royalties go back up to where they are now, and then they should have been down to 0.3 which would have been the proper outcome of HFE, if we adopted the PC's recommendation, then they wouldn't be. So, in a sense, Victoria would be worse off by the 900 million because the counterfactual would have been HFE would have been operating in 15 years' time under the current parameters.

20 **MS CHESTER:** I guess that gets us to the issue of we never know who the future outlier will be. Living in South Australia, it could be an outlier in 10 years' time.

25 **MR PALLAS:** I think we could take a safe guess that Northern Territory will be one outlier.

30 **MR COPPEL:** I'm conscious of time and in your submission on the draft report you make the point that if there are specific issues with the current process, it's better to adjust those directly. One area that has come up is the way in which the assessment is made for resource royalties. The CGC has proposed discounting 50 per cent of the increment of new resource revenues which is essentially also moving away from full equalisation. I'm wondering if you have a view on that suggestion from the CGC?

35 **MR PALLAS:** I think the first proposition I put before I answer that question directly but I'll give it a shot and then I'll ask David if he'd like to complement or add to that. The first point I'd say is have we started a process that we've become obsessed with getting a solution where there is no problem here.

40 **MR PALLAS:** I think the first proposition I put before I answer that question directly but I'll give it a shot and then I'll ask David if he'd like to complement or add to that. The first point I'd say is have we started a process that we've become obsessed with getting a solution where there is no problem here.

45 Whilst Western Australia might be unhappy about the headline number of what their GST share is, their receipts per capita are considerably more than



the State of Victoria. Let's be very clear about that, in terms of that they get from their State tax and royalty revenue per capita or in terms of what the total allocations that they get are from both State taxes, royalties and Commonwealth share. So, what's the problem we're fixing here, apart from a sense of grievance.

**MR COPPEL:** In this particular area, it's policy neutrality, because it's such a dominant iron ore producer that its decision can affect the average rate that's used then for the assessment.

**MR PALLAS:** When you say its decision, any decision it might make around royalty rates essentially. So, what we're saying is, despite the fact that they have a pretty clear projection in terms of where they think their revenues are going in terms of royalties and you say that you're satisfied with those observations, the practical consequence is if they were to choose to distort the projections, either by reducing their royalties or increasing their royalties, that that would distort the way that the GST parameters exist.

My answer to that would be, let's address that problem if and when it occurs. But at the moment, we don't have a problem. I think this is an inquiry in search of a solution to a problem that doesn't exist, quite frankly.

The second point I'd make is that so far as the Commonwealth Grants Commission was concerned, they I think pretty directly dealt with the question of whether or not they should move into the issue of policy neutrality around choices that States make around the extraction of onshore gas, for example. They made it pretty clear that they didn't see any role for themselves in getting in to the choices that the States make, because quite frankly, it's weighing up one industry, one economic opportunity against another in the mind of the State of Victoria.

In respect of the specific issue, I can't really add to my broader comments. David, you might have some observations to make.

**MR MARTINE:** I'll just make a quick comment, Treasurer. I'm sort of struggling to sort of understand the logic behind discounting one part of a State's revenue base. I mean it's a bit like sort of arguing that here in Victoria we should get a discount on our stamp duty revenue. If we're going to stick with the principle of HFE, then our view would be that the royalty revenues in a jurisdiction or stamp duty or whatever it might be, I mean that's part of the base.

**MR COPPEL:** I mean the CGC currently does discount quite a few specific revenues, own revenue sources, and they do that when they don't have full confidence in how they measure it.

**MS CHESTER:** I think the important point here is this is where the CGC is trying to do the trade-off between equity and efficiency. Where they're saying there's issues of policy neutrality, with mining royalties for WA because they set the average, thus they won't optimally tax that royalty, that revenue base.  
5 Thus, they've now got a live recommendation in their current methodology reviews.

It's relevant to our inquiry because we're sort of saying we think the trade-off is not being managed well at the moment. Here's the CGC, with the only  
10 levers that it's got, pulling and pushing on them. So, that's why it's a really pertinent question to ask in the context of this inquiry.

**MR MARTINE:** Yes, but once again, similar to my comment about elasticities, I don't see that as really a logical then direction towards the PC's  
15 recommendations of we would argue, in effect, carving WA out, because there's no question that there are things that can be improved in the current system. We have continuing discussions with the CGC and we have good robust debates with them whenever we have the methodology reviews and all jurisdictions do that.

20 Fundamentally, the system is working, if you accept the principle of HFE, because the alternative is you're going to equal per capita, because I think the recommendations in the draft report I think are moving away from HFE, and we would argue is making the system actually worse.

25 So yes, there are things that in the current system need to be addressed and we have continuing discussions with the CGC, particularly on the expenses side and some of the discounting there. Those discussions will always occur and we'll always be having discussions how to improve the current system.  
30 Fundamentally, our view is the current system of HFE is actually working.

**MR PALLAS:** I'll just try to supplement that by making the point, I think you'll find to the extent that you speak to the other States, and no doubt you've got their submissions, if you've managed to find a proposition that's earned a  
35 far degree of chagrin from most states, but with one notable exception.

The point that I think the Secretary made quite clearly is there's a fair degree of acknowledgment of the way that HFE operates at the moment. If you change it in the way that you're proposing, you lose the buy in of the  
40 States. You lose one of the great supporters of HFE in the State of Victoria, and you end up in a system where all the States are just saying, "Give us back what we put in".

45 We will lose something quintessentially Australian as a consequence of that. We don't want to have States in this country operating like certain States in the United States, and I won't name them, for fear of getting into trouble.

But their receipts are essentially substantially disparate from some of the other wealthier States.

5 We've made a genuine effort in this country to ensure that we provide an Australian way of life, and HFE is a key component to it. Whether or not the GST is the appropriate methodology for it, I think the debate's come and gone. From our perspective, we see that you need to tread carefully here because you will lose a large measure of consensus around the States, whether it's a robust endorsement or a qualified one that the GST has a role to play in HFE.

10 **MS CHESTER:** One way of looking at it is the HFE principle isn't just about equity and equality. The CGC actually does have other subsidiary principles and one of them is the efficiency and policy neutrality. We're now seeing a situation where the CGC is looking at turning on and off some of these levers that they previously hadn't contemplated. So, the 50 per cent discount on an increase in royalty rates for WA, taking CSG out of the GST pool consideration, similar to gambling for policy neutrality reasons.

20 What we're saying is that you're sort of presenting HFE as this equity and equality and the aspiration is fully achieved, whereas what we're seeing is it's not fully achieved for reasons Jonathan intimated before around discounting and the like, what's considered and what's not. Moreover, the CGC, because of the pressure on the system at the moment and getting that trade-off, they're starting to look at pushing some big buttons and making some material changes to the way that it's done.

30 **MR PALLAS:** I mean the headline that I got from the CGC's report was they remain robust supporters of the idea of policy neutrality. To the extent that they would move away from that, to the extent that they would actually advocate that the system alter, based on choices that the State make, I would oppose. I'd oppose it quite simply because where do we stop when we get into that area. Do we look at, for example, whether the leasing into the private sector of certain undertakings of the State should or should not be rewarded, a very hot political issue in the public discourse that's going on.

35 The point I make is if an administrative body is charged with the responsibility of ensuring that the tax base is operating fairly and the States are being given adequate opportunity and equity in the processes, as soon as you start getting into that space, how do you get out of it. Then the role that you perform becomes a political football with everybody arguing about whether or not their policy solutions are the right ones.

45 I've said some things today about what I think about the previous Western Australian administration. I'm sure there would be spirited debate from the contrary point of view. Really, all I'm giving you an insight into is the sort of slippery slope that I would argue strongly that this Commission, and indeed the CGC, should not be interested in getting involved in.

5 If that really means that the CGC is looking to dissipate the concept of policy neutrality, all I would say is that the State of Victoria would argue very strongly against it. Our sovereignty is something that we value importantly in this Federation. Going down this path, I think, only gets us to a point where every point you make is essentially a political one.

10 **MS CHESTER:** I've got two more little questions and I'll get into trouble from the team if I don't ask them. I'm very conscious of time, but also, I'm very mindful that I don't want to be seen to have mischaracterised the CGC. They are actually trying to secure policy neutrality with the sort of recommendations that they're making.

15 The two other questions, Treasurer, and one area where we do agree because there's much that we do agree upon in our draft report and your submissions and feedback to us, is guidelines for quarantining Government grants to the States. We know that certainly in the case of Western Australia recently, part of dealing with the outlier situation and the relativity falling was the Commonwealth Government making some infrastructure transfers of funds  
20 to the WA Government.

Your post-draft report submission says that you would only want to see quarantining occur, so not taken into account for the GST relativities, in exceptional circumstances. We kind of said the same in our draft report but  
25 we'd like to know what you think the exceptional circumstances might be because we struggle.

30 **MR PALLAS:** For example, if the State were to sell an asset to the Commonwealth and the Commonwealth were to pay for it, we would not see that funds to be seen in any way as a grant or, indeed, incorporated into an assessment of GST entitlements, to give you one relevant and probably real example.

35 **MS CHESTER:** On what basis, because it does change the fiscal capacity of Victoria by having received those monies.

40 **MR PALLAS:** Well, we're a vendor, in practical terms, and the Commonwealth, if they want to purchase from us the asset base of the State, we're simply converting an asset of value into dollars. Nothing really changes in that respect on our balance sheet.

45 In practical terms, for that then to be used as a justification to reduce the State's entitlement to GST, I would see as being – well, that would be one of the principles that would stifle the exchange, economic activity. The sort of issue that you highlighted around stamp duty would be writ large in the context of that sort of transaction. Let me say, whilst I have one in mind, there would be many others.

5 Let me be clear, I shouldn't be precious, the Snowy Hydro, the Federal Government are extremely keen to acquire it. I tell you, if, ultimately, I saw the State's entitlements in any way impeded out of the GST, well the answer would be "no sale".

**MS CHESTER:** To that extent, the HFE is an obstacle for your consideration of privatisation or the sale of assets? It is something that you take into account?

10 **MR MARTINE:** Only in the sense of if in the discussions with the Commonwealth, and it's quite rare – I mean the Treasurer made the comment about the Snowy, I mean we don't here in Victoria have – well, two issues, many assets left to sell. Secondly, it's quite a rare thing to be selling potentially, an asset to another jurisdiction. It only really sort of comes up in  
15 that particular context. It's a very, very rare unique thing, that particular example.

20 Your comment is quite right, it's a hard one to put a ring around what does "exceptional" sort of mean. I mean some times you may be in a situation where, for whatever reason, the Commonwealth Government of the day really wants to do something in a particular State and there's money available to it, to that particular State.

25 It can, in certain circumstances, be a bit unfair for the Commonwealth to come on and say, "We really want, Victoria, for you to do such and such and here's \$200 million to do it and make a big announcement about it". Then over here you discover that you've lost a third of it through the GST over three years.

30 **MS CHESTER:** But isn't that HFE working like you want it to, David?

**MR MARTINE:** No, but in that situation, it's not necessarily the State making a conscious choice that it actually wants to do that. Some times it's the Commonwealth actually wanting to achieve its own objectives in the  
35 particular jurisdiction and so it's a hard one because sometimes you're quite right, the HFE should kick in.

40 But other times, you could argue that HFE shouldn't kick in because it's really only being done because the Commonwealth of the day, Government of the day wants to deliver on something that's quite unique in that particular State. It is really hard, I agree, to put a ring around it, which is why we probably used exactly your words, which is "exceptional circumstances".

45 **MR COPPEL:** There are some principles in it, typically to the extent to which the Commonwealth is trying to achieve some national goal, in which case you would treat that funding separately from own sources of a State revenue. For

the case of an asset sale, I mean it's not an economic activity, it's just a transaction.

5       **MR PALLAS:** Let's give a real example around the interaction between the Commonwealth, the National Homelessness Agreement (NHHA), where effectively the Commonwealth have introduced legislation, the practical consequence of which is if the States don't make policy changes that have absolutely nothing to do with the Commonwealth. They are not within the Constitutional purview, then you will be compromised in terms of your  
10       entitlement.

Now, does that drive economic efficiency? No, and I think I run the risk of treading into political grounds here, but I think I would say the Commonwealth's interventions around housing affordability have been  
15       nothing but shambolic in this process and counterproductive. But to then try and use one policy level and a national partnership, which brings with it an implied loss of sovereignty that the States with open eyes go into, yes, we will contribute a certain amount of our funds in partnership with the Commonwealth within this area of activity.

20       For then the Commonwealth to say that's not all we're interested in, we'll give you the money and now we're going to go to the front of the bus and drive it and tell you what else you should be doing in order to get the money, that essentially the States could have become accustomed to receiving, because it  
25       may have been one or two or three iterations of national partnerships.

Changing the rules, the loss of fiscal independence of the States through the leveraging of national partnerships, all of that has a profound and negative impact upon the sovereign responsibilities of the States.

30       This sort of shambolic movement from one policy obsession to another, makes it incredibly difficult for States in the long term to manage budget planning. What we don't want to see at large, in effect, is this principle of policy neutrality starting to infect the GST.

35       **MS CHESTER:** I think that sort of brings us back to one of the earlier points and probably for us the more significant policy issue needing to longer term around vertical fiscal imbalance. If that were to be addressed in Federal financial relations somewhere down the track, Treasurer, do you see the HFE  
40       would evolve as well?

**MR PALLAS:** I suppose we're looking a fair way down the track in the future.

45       **MS CHESTER:** The Commission's in this for the long play, Treasurer.

**MR PALLAS:** Good, good. I'm glad to see a sign of your commitment. My observation about that is the fundamental principle of HFE has to be I think preserved and that is the States have some sort of equity in terms of their per capita share of funding and for me, that's the final principle.

5

It's not just State taxes and royalties. Over time it will be that mix between State and Federal. If you went back to the earlier graph that I showed you, essentially identifying the State and Commonwealth totality of per capita allocations, once again, Victoria is down the bottom of that charge.

10

If, for example, that blue level, because it started to drop away even further, Commonwealth funding, because of variations to VFI, the advantages of States in their own revenue, I would not have a problem with that change in mix between blue and red, as it were, of funding source.

15

The principle that, really, we're seeking to preserve here is the idea that the States in a policy neutral sense can make decisions that impact upon the material circumstances of their populations, and that we've got an expectation that we can budget into the long term and have some confidence that our revenue base won't be eroded.

20

**MS CHESTER:** One final question before I allow you to escape. I know we've gone well over but it's been a very good session from our perspective and I hope from yours. On data, and I thank you very much for in your post-draft report submission agreeing with us about allowing the data that the CGC holds and their own calculations to be shared with the public. As we sort of grapple with the transition path, and this might be more a question for your Secretary, how far out do you forecast relativities at the moment for GST and would you be able to share those with us to help us with our work around transition path.

25

30

**MR MARTINE:** Essentially, like every jurisdiction, including the Commonwealth, our budget forecasts are only for two years. At the moment we've got '17-18 and '18-19. They are our genuine forecasts, and then beyond that, like all jurisdictions, we project and you project to sort of the - - -

35

**MS CHESTER:** Sorry, I should have used the "P" word, not the "F" word. How far out do you project and would you be able to share those with us?

40

**MR MARTINE:** Yes, I'd need to sort of have a look at it. I was going to mention before we finished that I'm more than happy to make my department available to the Commission, as I think we've already been doing, to flesh out some of the more technical aspects of our report, but let me have a look at that.

45

**MS CHESTER:** That would be great. We would welcome that help and involvement.

**MR MARTINE:** Okay, thanks.

5 **MR PALLAS:** I think I should at least give my department some acknowledgment too, Deputy Chair, both for the presentation that they put together and also - perhaps I'm not allowed to say this, David, but I will. We did an assessment of our GST share, at the numbers that we would get in GST in '16-17 budget and when the final audited accounts came back – now, remember there's a fair bit of assessment and calculation – it came within a very small amount of being right on, right on the bullseye.

10 The point I make here is the fact that we could assess under the methodology of the GST where we were likely to land is not only a tribute to their skills and capacity, but also to the fact that that predictability helps us in terms of forward budget planning.

15 **MS CHESTER:** We've benefited from their very professional help with us during this inquiry and engagement and we look forward to that continuing as we try to get to the finishing line. Thank you very much, Treasurer. Thanks, David. Thanks, Amy.

20 **MR PALLAS:** Thank you.

**MR MARTINE:** Thank you.

25 **MS CHESTER:** Sorry, folks, we are running a little bit late. I'd like to call our next participant, Peter Brohier, to join us. Good morning, Peter.

**MR BROHIER:** Good morning, Ms Deputy Chair.

30 **MS CHESTER:** If you'd just like to state your name and who, if any, you represent. I know we've met before in my previous inquiries in Tasmania.

35 **MR BROHIER:** I'm a little bit hard of hearing and also sight but I am Peter Brohier. I'm not representing anyone but I chaired probably the largest commercial committee at one stage that convinced a couple of Prime Ministers to do something significant in relation to Tasmania and Victoria.

40 **MS CHESTER:** Peter, thank you very much for being a participant in our inquiry and thank you for your submissions that you've made to us. Jonathan and I and the team have read those in detail. Is there anything else you'd like to say in addition and briefly in addition to those submissions?

45 **MR BROHIER:** Yes, I would and I've heard the Victorian Treasurer this morning. It seems as though there somehow is an issue of dividing up an existing cake of GST revenue. I believe in the case of Tasmania that that cake could be grown very significantly very quickly.



From my experience over the last 20 years, I've seen a massive Federal scheme able to drive the whole economy of Tasmania turned into subsidies. When added to other subsidies in ways that Canberra has benefited Tasmania, I could basically come to the conclusion that Tasmania is really run by subsidies. We gave, or my committees, gave Tasmania the opportunity of having an equal transport link, the sort of thing that was contemplated by federation. Federation was an idea to integrate the economy of this nation by linking the States and moving freight and people. Now, my focus is on people.

The idea was that our Bass Strait issue was to integrate the Tasmanian economy and allow virtually the Hume Highway to extend to Tasmania via Melbourne to Tasmania, but by using the ferries as though they were part of the highway system. That scheme, almost from its inception, but certainly five years later, had been turned into a subsidy arrangement. It was extremely hard to get a scheme put in place that would do that. Tasmania has, probably maybe since the shipping lanes of the world were discontinued, effectively, as connecting the colonies, Tasmania has gone backwards. It's gone backwards because it hasn't been equally linked. All the other States have enjoyed an integrated transport system that Tasmania hasn't.

It's my contention that right now, with the existing funding that we got 20 years ago, it's uncapped, demand-driven funding, dealing with Bass Strait. That funding could be used almost immediately to change the way that funding is actually applied by the operator who is owned by the Tasmanian Government to actually deliver that extension of the Hume Highway right down the Midland Highway, right to Hobart.

**MS CHESTER:** Peter, I might just see if I can pop in and ask a question here, because I know we dealt at length in a previous inquiry with the Bass Strait Passenger Vehicle Equalisation Scheme. I guess what we're focusing on today is horizontal fiscal equalisation. Could you just explain to us what change you think needs to occur to the way we do horizontal fiscal equalisation with respect to Tasmania. If you could just focus your remarks on that, that would be really helpful.

**MR BROHIER:** I'm happy to but I was just setting the scene because the scene is important. My contention is that the States ought to be treated equally first up. The idea of Federation was to link the States into this integrated national economy. I don't think Tasmania is integrated. It's operating virtually on a separate economy and we are funding HFE payments to Tasmania to help with that situation. The whole situation can be changed. We shouldn't be comparing Tasmania with Western Australia and South Australia and every other State. We should be making Tasmania an equal State in our Federation, which was the intent of Federation and, as I say, can be achieved by a very simple linkage of Tasmania to affect its whole economy.

5       Once that economy is affected, then you can make the division of HFE in terms of how much should go to the Tasmanian people and how much should go to the Western Australians. Otherwise, what you've got is a State with virtually a self-imposed impediment to its development, right there with the opportunity to change it immediately and to increase its GST contribution, and to make HFE expenditure in Tasmania work much more efficiently, because you're spreading your Commonwealth HFE payments to Tasmania, or Grants Commission payments to Tasmania, where you've got a population increase.

10       You've got a viable movement of people within Tasmania and out of Tasmania. This is not a small thing. It's got the ability to drive maybe the generators of about 70 per cent of gross State product. Currently, I would suggest, with the present configurations of turning this equalisation scheme into a subsidy, you're driving about 7 per cent of the Tasmanian economy with a flow-on trickle effect maybe to some others. You can immediately change the size of the cake. HFE could be an overlay over that and I think your paper hasn't dealt enough with that.

20       You also, I think, suggest that there's no proof of things like that. Well, I've watched a massive scheme that can change an economy and did change an economy. When the scheme was first introduced, it changed it so much that the Economist magazine reported the changes worldwide.

25       **MS CHESTER:** Our main takeout from your submission and your opening remarks and thank you for those is you don't want to change HFE but you think before we overlay HFE, your longstanding recommendation for a land bridge between Victoria and Tasmania needs to be in place.

30       **MR BROHIER:** It needs to be in place and the psyche of Tasmania needs to change to have the same rights as Western Australia and other States. Once you connect them – so, I believe in transport equalisation. It's not just about my idea for Bass Strait. We were a huge committee and we convinced the nation to fund such a thing. I'm not here because of that. I'm here to say if you're going to start funding HFE contributions to Tasmania, get the platform right, based upon Federation, and then move to the second level of service delivery equalisation as part 2.

**MS CHESTER:** Did you have any questions, Jonathan?

40       **MR COPPEL:** Not at this point.

**MS CHESTER:** I don't have any more.

45       **MR COPPEL:** Maybe then I'll ask you a question about - - -

**MR BROHIER:** Sorry, could you speak up a little bit because I'm very hard of hearing?

5 **MR COPPEL:** Sure. Sorry, I speak very softly, so if I speak louder I'll lose my voice, but I'll do my best. You make the point that the system of HFE is providing some form of implicit subsidy to Tasmania and that those funds could be better used, first off by making the Tasmanian economy more integrated with the mainland. My question to you is if there were this type of link between Tasmania and the mainland, would that itself provide that level of integration that you think would then be the sufficient step to then think about HFE?

10 **MR BROHIER:** Given that Tasmania's largely a service-based State that needs people, the movement of people between the biggest population centre in TT-Line has even made comment about that. So, it would drive a whole economy, set the right pattern or position for Tasmania, and would also benefit  
15 Victoria with the flowthrough of people through Victoria to Tasmania and back again.

20 This is not hypothetical. This has been an actual opportunity that Tasmania has had, but someone has fiddled with the system and turned it into another subsidy. If we keep doing that and then have Western Australian taxpayers fund Tasmania as though it was an HFE payment properly allocated, what we're doing is, instead of looking at bounties on one end, this is like a bounty for Tasmania that's an obligation under the deal they did at Federation.

25 What we're doing is we're not accepting that. We're taking Western Australia over here but we're leaving Tasmania here and not putting that rigorous obligation on them. There's no obligation for money. We gave them the money. The money's there. There's slight adjustments that need to be made that could be made overnight and you would have that Hume Highway flowing into the whole of Tasmania, and I'll tell you what, your GST take and  
30 everything else would change.

**MS CHESTER:** Peter, we thank you very much for your submissions and for appearing here today. We don't have any other questions for you.

35 **MR BROHIER:** That's good. Thank you.

**MS CHESTER:** I'd like to now say that we'll just take a short five-minute break and then we'll resume in five minutes. Thank you.

40 Thank you, Peter.

**MR BROHIER:** Thank you.

45 **ADJOURNED** [10.38 am]

**RESUMED** [10.45 am]

5 **MS CHESTER:** Folks, we'll resume the hearings, and I'd now like to welcome Dr Vince FitzGerald and Jerome Fahrer from ACIL Allen to join us and welcome. Thank you very much because you've both been very generous during the course of our inquiry with meeting with us and also with the submissions that you've provided and the work that you've done with and for the New South Wales Government and we're very appreciative of that.

10 Just for the purposes of the transcript recording, if you could each just state your name and organisation and then if you'd like to make some brief opening remarks, that would be great.

15 **DR FAHRER:** I'm Jerome Fahrer from ACIL Allen Consulting. On my right is my colleague, Vince FitzGerald.

**DR FITZGERALD:** I'm Dr Vince, or Vincent if you prefer, FitzGerald, and also a Director of ACIL Allen Consulting.

20 **DR FAHRER:** Thank you, Commissioners. As you are aware, we have through this process provided some advice to the New South Wales Treasury, but I do want to emphasise, and for the record, that we're here speaking for ourselves. We're not here speaking on behalf of the New South Wales Treasury or the New South Wales Government. Their views are their views.  
25 Our views are our views and, as they say, any overlap is merely coincidental.

It's not our intention to say much by way of opening remarks, just a few points and maybe we'll just tease out what we have to say through question and answer, because there's more topics than there is time to talk about. So,  
30 we'll concentrate on what you want to talk about, rather than what might want to talk about.

Just quickly, just by way of preamble and just to set the scene and our view on the system, the first thing you have to say is that the HFE system as it exists today is complex. It's overengineered and it's opaque. Very few people  
35 understand it at more than a high level. That, in itself, is undesirable because you can't have such an important system of fiscal transfers which hardly anybody understands. It's just undesirable for that reason in itself.

40 The second point is that while some horizontal equalisation is desirable, there's nothing in the theory or international practice of HFE to suggest that the Australian system of 100 per cent equalisation is optimal. This is a peculiarly Australian practice and institution and we shouldn't assume that it has to be this way. In fact, our view is that it ought not to be this way.

45 Third point is that you can't meaningfully talk about reform of HFE without talking about reform of vertical fiscal imbalance in Australia. If there

was less vertical fiscal imbalance, which is to say the States could raise more of their own revenue, there would be less of a need for these equalisation payments.

5           The fourth point, and this is just a bit by the by, this inquiry and current national discussion has been driven by the Western Australia experience. I don't think we should get too hung up on that. What the WA experience is, is the residual effect of a once in a century mining boom which may never happen again, not in our lifetimes in any case.

10           What the Western Australian experience does show though, or brings into sharp focus, is the problems of the current system. The fact that it relies entirely on relativities and unilateral action by one State can have negative effects on that State's fiscal outcomes, although I think it can be shown that  
15           Western Australia's budget problems are largely of their own making anyway.

**DR FITZGERALD:** May I just interpolate that. Part of the roots of the Western Australian problem is the treatment by the Commonwealth Grants Commission of all tax bases as completely non-substitutable, whereas in my  
20           view every State and Territory, if it has modest or poor prospects of raising money from tax base A, has many other tax bases that they can look to to raise the money.

25           So, part of the Western Australian problem is that because it's the only State – give or a bit in New South Wales – that has iron ore, all the other States are treated as being completely bereft of iron ore, but ignoring the fact that they have other possibilities to raise tax.

**DR FAHRER:** The penultimate point I want to make is that the zero-sum  
30           nature of the system makes reform extremely difficult, if all you're trying to do is reform the HFE system because it means that any change which causes any State to lose one dollar can, in practice, be vetoed by that State.

35           That means that tinkering around the edges, equalising to the second highest State, rather than highest State, or giving discounts here or giving discounts somewhere else, is really not going to help you very much. It's just going to upset the status quo, which will make some State worse off than it would otherwise have been. They will say no, and that will be the end of the discussion, unless HFE reform is combined with other reform, in particular,  
40           VFI reform but, while we're at it, tax reform more generally. You've got to do them all together. But this is not news. We've had a go at it, Vince and I, in various roles over the years. It can be done.

45           As for the particular proposals put forward by the CGC in its submission and its principles paper and other technical aspects of the system, well perhaps we can just deal with them in question time.

**MS CHESTER:** Great. Thanks, Jerome. Vince, did you have any other opening remarks you wanted to add?

5 **DR FITZGERALD:** I would just make this observation, that the philosophy of horizontal fiscal equalisation as it has been developed notably by the CGC itself in recent times is light years away from what was originally the genesis of section 96 in the Constitution, which said that, and it was actually in response to WA as well. WA was threatening not to join the Federation unless it was given special financial assistance because it was in fiscal difficulty at  
10 the time.

Hence, the founding fathers brought in section 96, which said that for a period of 10 years - it was supposed to be sunsetted - but thereafter until the Commonwealth other decides, the Commonwealth can provide assistance to a  
15 State on any terms that it sees fit.

In what I consider to be a bizarre interpretation by the Courts since, that condition has been judged to be legitimately a condition where the Commonwealth requires the States to forgo the exercise of a power that they  
20 have somewhere else in the Constitution. For example, their still extant Constitutional ability to raise income tax. The Commonwealth passed legislation during it, after the war, to make sure that any State that dared to raise its own income tax again would be severely punished by reduced grants.

25 What we had originally was something that was intended to be a fairly simple form of horizontal fiscal equalisation. Liberally interpreted, it was that if any State was in fiscal difficulty to the extent that it could not provide a reasonable level of services to its citizens, then the Commonwealth was empowered to give them assistance so that they could.

30 That is very similar to the philosophy of fiscal equalisation in most other Federations, that there is no attempt to comprehensively equalise, but to make sure that, whether it be a Prince Edward Island or some other poor province in the Federation, would be given enough assistance from the central Government out of its resources to be able to provide services that are reasonable or decent,  
35 minimum acceptable to citizens of the whole Federation.

That philosophy, it seems to me, would be a much better start than comprehensive equalisation, as we have now.

40 **MS CHESTER:** Thank you for those opening remarks. We might start where Vince has taken us and that is that history kind of reveals much here and, indeed, in our draft report we did touch on the evolution of the adjective and what adjective was stuck in front of the word “standard”.

45 The reason I raise it is more in terms of what that might mean in an institutional and a governance sense, because the best that we’ve been able to

untangle is that no Commonwealth or State or Territory Government ever sort of signed up to the same standard. It just involved by the CGC, which is a statutory agency. It was part of our report, the issue of what role should the CGC be playing here and what role, indeed, should the Commonwealth be playing here in a policy sense in setting the objective.

**DR FITZGERALD:** The CGC itself, if you go back to the reason it was established, was to ascertain when a State claimed to be in fiscal difficulty how much it needed and it wasn't done in the way that they do it now. I'm sure it was in a way that looked to some concept of reasonable or minimum acceptable level of services and how much they would need and for how long to be able to do that. I think that it would be a far better system if you stuck to that sort of philosophy, rather than to comprehensively equalise everyone to the average and to do so within the straightjacket of a zero-sum game, which, by the way, the Commonwealth could change if it ever wanted to, as long as it could get a majority in both houses which might be a bit difficult. It certainly would be a useful element of any attempt to reform to remove the legislated veto of any State over any kind of reform of the GST, even say broadening the base or raising the rate. That, in other words, means it's a big impediment to vertical fiscal equalisation or vertical fiscal balance reduction, as well as bedevilling attempts to reform HFE.

**DR FAHRER:** If I might add a couple of words on governance. The CGC does seem to have an extraordinary amount of discretion and power, if you like, in interpreting the general policy. It has this because (1) the system that it administers is so complex and, (2) because it's open to its interpretation. So, as we understand it, and we've heard this from more than one State Government, if they're considering some tax reform, in some cases they don't know how the CGC is going to interpret what they do, so complex and so uncertain are the CGC's processes, and that's quite an extraordinary situation.

**MR COPPEL:** On that point, we make in the draft report a recommendation that there should be the option or the possibility for a State to ask the CGC for a draft ruling, a bit similar to the ATO. I'm wondering if you had any views on whether that's a solution?

**DR FAHRER:** As long as it's a binding ruling, ATO-like, that would be a very good thing. There are genuine issues of interpretation about is this a new tax. Is this a new tax or an extension of an old tax? This makes a very big difference or can make a very big difference to the amount of GST that each State ultimately gets or loses from a particular reform. The CGC, I mean we're not going to say it's a law unto itself but it does possess quite a large amount of power and discretion and nobody seems to be able to do anything about it.

**DR FITZGERALD:** One of the most obvious cases is the reform which many economists, not only here but in the UK where I have been until late last night,

the idea that instead of having a transactions tax on property transfers, there should be a land tax. All economists know the arguments for why that would be an efficiency enhancing reform. The difficulty is that on the most likely interpretation by the CGC here, any State which did that unilaterally on any scale, would lose most of the proceeds to the other States through the HFE process. So, the only way that could happen would be that if all or nearly all States did it together. Bringing that about is, again, subject to the bedevilling influence of the zero-sum gain concept, and the fact that any reform like that is going to be politically difficult anyway, whether you do it solitary or in company with a number of other jurisdictions.

**DR FAHRER:** There's other examples. The CGC decides whether a tax or a tax base should be distributed on an EPC, equal per capita basis, as it has done with gambling taxes. Now, I personally happen to think that's the correct decision, but it's their decision, and that makes a big difference.

**MS CHESTER:** Yes. Indeed, when you sort of look at it, the Treasurer can instruct the CGC at any time, but the Treasurer needs to have that predisposition and to be appropriately briefed.

**DR FAHRER:** Yes.

**MS CHESTER:** Thus, effectively take the CGC in the right direction where it is making policy neutrality decisions and they are policy decisions. I guess in our draft report, our answer to that was suggest Commonwealth Treasurer step up to the plate, and by default, Commonwealth Treasury stepping up to the plate and perhaps playing that role, a little bit more than they otherwise would.

**DR FAHRER:** Yes.

**MS CHESTER:** On this issue though of the policy chill and the point that you made, Vince, about why would a State dare greatly and reform the way that it taxes transactions versus land tax when it's going to get whacked by losing out on the GST. Indeed, we did some cameos because this has been an area where we've struggled to get any evidence from State Governments about to what extent does the HFE system at the margin or beyond act as a disincentive for you having in place good policies, whether it be digging stuff out from under the ground or from having the right taxation system at the State level.

Apart from WA and New South Wales that have a motivation to want to change the current system, everybody else says, "No, we've got it wrong". Indeed, we heard from the Victorian Government this morning and from their post-draft report submission to us that our numbers of losing \$700 million to \$1 billion a year from the GST for a large State is actually only \$10 million, because they don't take into account the elasticity effects. It is an area we do



want to tease out with you.

**DR FITZGERALD:** If you listen to a previous Victorian Government of the same colour, you would get a different answer.

5

**MS CHESTER:** Treasurer Brumby.

10 **DR FAHRER:** Elasticity effects, look no doubt somebody in the Victorian Treasury assumed an elasticity or got an elasticity from somewhere and worked this out, and that's probably the number that they came up with. Maybe they used the same right elasticity, maybe they didn't. Maybe their analysis was right, maybe it wasn't. Obviously, there's room to disagree, genuine room for disagreement here. The fact that it could be little or it could be large, the impact is in itself an important consideration, because it means  
15 the States don't know. I mean the boundaries of the possible effects could be very large. If I'm a State Treasurer and my officials say to me, "Well, we don't actually know what the impact would be. It could be small, it could be large, and the CGC won't actually tell us". Well, that in itself is likely to be a chill.

20 **MS CHESTER:** We heard evidence this morning that the Victorian Government use it as it's always small and thus it doesn't figure in consideration or deliberations by Cabinet when it comes to tax changes. I guess from your collective experience, you've worked with State Governments, we're seeking evidence that our cameos, which we think were  
25 reasonable cameos and, indeed, we had an interval of assumed elasticity effects, are reasonable in terms of saying, "Yes, this is an actual disincentive for States making those decisions".

30 **DR FITZGERALD:** The disincentive is potentially very large, only in the case of pioneering a new tax base. No one would suggest that it is a very large disincentive to altering the rate of an existing well-established tax base that all the States use. But it just so happens that some of the more interesting areas for potential reform that would improve the efficiency of the Australian economy generally, happen to be of the former kind, where someone has to  
35 plunge in and consider some real reform like the land tax instead of transaction tax to property.

40 **MS CHESTER:** Are there any cameos? Since we're not going to get this evidence base from the States, are there other cameos? We were a bit pressed for time in getting our draft report out. Are there other cameos that you think that we should be running to try to capture that disincentive effect?

**DR FAHRER:** Other than the ones you've already done?

45 **MS CHESTER:** Yes.

**MR FARHRER:** Well, that's a good question.

**MS CHESTER:** You can come back to us on it if you don't have an answer on the spot.

5 **DR FAHRER:** Yes, okay. We might take that one on notice.

**DR FITZGERALD:** We did, using the best numbers we could, run a number of things. The one I've mentioned a couple of times now is the one which is the clearest. The others are fuzzier.

10

**DR FAHRER:** That's with tax where it's relatively easy to work out. With expenditure reforms, it's even more opaque and difficult.

**DR FITZGERALD:** To get numbers even, yes.

15

**MS CHESTER:** What would be some examples of, from an economist's perspective, a meritorious expenditure reform that a State could do where they really can't work through what the implications might be for the GST relativities? Again, you can come back to us.

20

**DR FAHRER:** We'll think about that.

**MR COPPEL:** You made the point that there are multiple tax bases and that should be a consideration in the CGC's process. One area that has been suggested many times is to rather than do an assessment on each revenue source, have some form of global assessment for revenue to be policy neutral.

25

**DR FAHRER:** Yes.

30 **MR COPPEL:** It's been looked at and never really concluded in a way that this would be a preferable alternative. Do you have a view as to what could be some other form of global measure or revenue capacity or partial revenue capacity?

35 **DR FITZGERALD:** A number of them. I guess the reason, to answer the second part first, the reasons why the global indicators approach has probably not been adopted is that if you take a Territory like the ACT, where the income levels and wealth, per capita wealth levels, appear to be well above the national average, global measures would have to somehow take account of the fact that  
40 the Commonwealth doesn't pay tax, doesn't pay payroll tax, which is an important tax for all the States and Territories. For the ACT it's pretty meagre because it's a company town and the company don't pay.

45 The Commonwealth doesn't pay other taxes to the Territory. If that were rectified by the Commonwealth making ex gratia payments in lieu of payroll tax and some other important taxes, then that would remove one of the biggest, obvious barriers towards going to that approach. Certainly, I think that the

ideal system wouldn't treat every single little tax base, and even divide the payroll tax into a whole series of vertical slices as treating them as different tax bases.

5        There's possible reform without going to it completely to the global  
indicators approach like GST per capita or whatever it might be by, for  
example, in the case of the payroll tax and not treating all these slices as  
different tax bases. They're all the same. They're all part of the same tax base  
and the hair splitting that the CGC does in that case is a good example of, I  
10      think, what not to do.

**MS CHESTER:** Two follow-ons then. In terms of the way they currently  
dice and splice the revenue base, what impact is that having then on States  
getting the call right on the way they tax their revenue bases?

15      **DR FAHRER:** Again, this is a bit of a controversial, difficult area. What  
we've looked at closely is payroll tax, where the payroll tax reform would  
cause States to lose – unilateral payroll tax would cause a State to lose GSP  
revenue. Unilateral payroll tax reform, it's the classic reform of lowering the  
20      rate and getting rid of the exemptions, not all of them.

**DR FITZGERALD:** Which would make the payroll tax similar to a VAT.

**MS CHESTER:** Yes.

25      **DR FAHRER:** Which just about everybody thinks is a good idea in principle.  
Again, there are genuinely divergent views from experts here about whether it  
actually would have that effect on HFE, depending on the CGC's treatment of  
how it all goes. It's not in itself very helpful, but the fact that the handful of  
30      people whose day job it is to work this out can't agree amongst themselves, I  
think is indicative in itself, and it's just unnecessary, this sort of finely diced  
overengineering of a system just to shift it at the margin a few dollars here and  
there.

35      **MR COPPEL:** This work you mentioned, is that recent work?

**DR FAHRER:** It's work we've done internally for ourselves.

**MR COPPEL:** Is that something that you could share with the Commission?

40      **DR FAHRER:** Well, we'll take that on notice.

**MS CHESTER:** I appreciate you might need to get clients' okay. On the  
revenue side then, if the primary obstacle is the Commonwealth not paying a  
45      payroll tax - - -

**DR FAHRER:** That's in the ACT.

**DR FITZGERALD:** The ACT is the obvious blockage.

5 **MS CHESTER:** The outlier. If that's the key impediment, would one  
halfway house be actually moving to a broad-based revenue indicator like a  
GSP and then doing a one-off adjustment. Given the current fiscal position of  
the Commonwealth Government, instead doing a one-off adjustment to that  
calculation for States and Territories, where there is a significant percentage of  
their employment bases as Commonwealth employees.

10

**DR FAHRER:** Perhaps, but this only goes to the question of the ability to  
raise revenue.

15

**DR FITZGERALD:** It's not just that, it's that they don't pay any taxes.

**MS CHESTER:** Yes.

20

**DR FAHRER:** I mean this doesn't get to the question of disabilities and  
expenses. The Northern Territory has pretty high GSP per capita, I think. I  
haven't looked at the figures recently but that's my impression. It costs a lot  
of money to deliver services in the Northern Territory, especially in the remote  
Northern Territory. Global indicators might get you somewhere in terms of  
ability to raise revenue. They're not very helpful for the other side of the fiscal  
question.

25

**MS CHESTER:** No, and I was only looking at addressing the revenue side  
of the equation.

30

**DR FITZGERALD:** If the states were allowed to collect income tax again  
and back in the late 90s in debates – was it late 90s or late 80s? Nineties, I  
think.

**MS CHESTER:** It was late 90s, yes.

35

**DR FITZGERALD:** When there were those discussions that led to so-called  
a new tax system. One kind of option that was on the table was that the States  
would be allowed to re-enter the income tax system in one of two ways. Way  
1, which I briefed a couple of States to push forward, was to have say the first  
10 per cent or the States to get 10 per cent of the income of its residents about  
the tax-free threshold.

40

45 The alternative, which Commonwealth officials preferred in those  
debates, was that the States be given simply 10 per cent or some like number  
of the income tax raised in their territory. In other words, without sharing in  
the progressive structure as well as having a flat tax. In either case, States, it  
was envisaged, could be permitted to have a surcharge or a discount.

5 It would never work unless the Commonwealth actually gave the States the tax capacity by reducing its own take to the extent that it gave the States that ability. It was, therefore, for the Commonwealth to get its books in order would need to, say, make uniform percentage cuts to what are now called partnership payments, SPPs then, or some other way to have a roughly zero effect on the Commonwealth's bottom line.

10 The idea was then that the States would be in their own hands to raise or lower their percentage and that would mean that, for example, if we had broad indicators approach, it would work a lot better in the ACT than the Northern Territory, because if they were short on some tax bases, they could have a, say, 1 per cent or 1.5 per cent surcharge on income tax.

15 Again, what this leaves you to is to see how solutions to HFE are bedevilled by the lack of VFI, or in the extreme, lack of reform to VFI.

20 **MS CHESTER:** Yes. Indeed, it was interesting looking at the CGC's post-draft report submission when they unbundled more about the different steps of HFE and what's required to get to assessed expenses. Even WA doesn't get to assessed expenses when you equalise to the highest. Because of VFI they still need that top up above their own current fiscal capacity.

25 This kind of gets us back to, I guess, Jerome, listening to you at the beginning around there's only so much you can do with HFE in isolation of not really dealing with VFI and Federal financial relations more broadly. We do countenance that in our report. We say longer term HFE could evolve in the context of changes to VFI and Commonwealth, State spending responsibilities. We're not in that world at the moment and nor does our inquiry allow us to get too much further into that world. I sort of got a sense from your earlier comments that we shouldn't even bother trying to look at some of the reforms to HFE that we're sort of contemplating in our draft report in the absence of being able to get into VFI.

35 **DR FAHRER:** I appreciate that you're bound by your Terms of Reference, but in the event, you've got to say something. Ad hoc changes to the existing system are not going to be very helpful and the CGC modelled some of these in its submission. What happens if you equalise 90 per cent, rather than 100 per cent? Well, why not 80 percent? Why not 70 per cent? I mean this is completely arbitrary and ad hoc and it adds even more complexity to an already complex system. But not just that, any change is going to create losers and the losers are going to say no.

45 **MS CHESTER:** If we park the losers for the transition path, moving to say equalising to the average and we're re-cutting the numbers to see what happens to our cameos. It looks like from the initial numbers, those disincentive effects are much less and you would intuitively expect that because, as you move more towards EPC, the disincentives dissipate.

**DR FAHRER:** Yes.

5 **MS CHESTER:** I guess what I'm trying to say is are there still economic benefits, because I mean basically we've got to be able to prove in our final report that there are economic costs to the Australian economy to the way we're currently doing HFE, and thus moving away from it in the absence of VFI being fixed is still a net economic benefit.

10 **DR FITZGERALD:** I'd suggest that moving to the average, instead of what effectively is the highest as the standard, would be helpful because it goes nearer to the concept which I think the founding fathers, and there were probably founding mothers too, but that's a different matter. But the people who created the Constitution, and especially section 96, I believe if you read  
15 the history, had in mind giving a State that might temporarily be in fiscal difficulty the ability to deliver services at a decent, reasonable standard. In other words, not to the standard of New South Wales or whoever happened to have the most generous range of services at the time. It seems to me that equalising to the average is considerably closer to that than what we've seen  
20 the CGC do.

In my opinion, it would be even better if there were a process of assessment as there's already work that would be helpful to. For example, in  
25 health costs we have long had the system of looking at so-called diagnosis related bundles of services in the hospital system, and there's a methodology that's been used for years now to work out what's the efficient cost of delivering one of those diagnosis-related groups. You could, in principle, do the same in the other big bread and butter service delivery areas like education, law and order, and local roads or something like that. But if you don't really  
30 want to do all that work, then equalising to the average is getting closer to it.

**DR FAHRER:** There's some other relatively low-hanging fruit, if you're just going to be talking about reforming the existing system. I think serious consideration should be made just to take Northern Territory out of it, because  
35 it's such an outlier in terms of its relativities and its disabilities. Now, that doesn't mean the Northern Territory should get less money, maybe it should get more money. There's a merit in not having the Northern Territory's disabilities affect everybody else's relativities.

40 **DR FITZGERALD:** It's also worth commenting that the fact that indigeneity and remoteness mean that the Northern Territory is assessed as having a huge need to equalise for, say, welfare services and never spends anything like the assessed amount. In fact, in the past it's not even spent the national average.

45 **DR FAHRER:** To be specific, on the latest figures, the Northern Territory's assessed expenses are \$1728 per capita and so it gets funded as if it would spend that much, but it only actually spends \$1169 per capita. That's \$559 per

capita of money it gets, in effect, to spend on welfare services, it gets from the HFE system that it doesn't spend, and then it chooses to spend on other things like industry assistance.

5 **DR FITZGERALD:** Some other States do this on a lesser scale.

**DR FAHRER:** Yes, all States do this. I'm not picking on the Northern Territory in particular, but this is the exemplar. This is taking the policy neutrality and autonomy a little far, I think.

10

**DR FITZGERALD:** And frankly it doesn't pass the pub test, so-called, to give the Northern Territory money to spend to the national standard and it considerably underspends that serially and spends it in Darwin or somewhere.

15 **MS CHESTER:** That's kind of an area that we struggle with a bit in the draft report, given that the GST money is meant to be spent under the guise of State autonomy, albeit the assessed expenses are just that, assessed expenses. They're not actual expenses, the outcome. On indigeneity, we struggled about taking it out because doing that in the absence of having gotten  
20 Commonwealth and State responsibilities right in that spending area, we're not sure just taking it out was the fix.

**DR FAHRER:** I agree that you need to do other things, but it's our view that indigeneity, and this is largely a Northern Territory question but certainly not  
25 entirely a Northern Territory question, but the problems of indigenous people should be treated as national problems, not as State problems, and they should be sorted out with national money. Having indigeneity as part of the CGC process is just unhelpful.

30 **MS CHESTER:** Can I just come back to - a lot of the evidence and a lot of the feedback that we get from certain States and Territories is about what HFE is meant to be or how it's currently practised, and they all talk about comprehensive equalisation. CGC does also have some subsidiary principles and one of them is about efficiency in policy and neutrality. It would be just  
35 good to get your sense of how well they're grappling with that trade-off, given the way that they sort of implement HFE today.

We've seen more recently they seem to have a bit of an appetite in their most recent report to sort of turn on and off some of the levers that they've got.  
40 So, like potentially discounting by 50 per cent mining royalties for WA by an increase in royalty rates, taking coal seam gas out of the equation, like gambling. These are areas where we suspect they're trying to get that trade-off between equity, equality and efficiency right. I guess it would be good to get your sense of how well they're doing that and how well the system can do  
45 it.

**DR FITZGERALD:** Surely if you took policy neutrality literally to the final

degree you wouldn't take out coal seam gas, if a State had that tax base and chose not to use it, that would be a penalty.

5 **MS CHESTER:** I think they're just stopping them getting a reward, Vince, by taking it out.

**DR FITZGERALD:** Yes, well, there you go.

10 **DR FAHRER:** What this shows is that the CGC has, in effect, become a policy maker. I mean these are really policy decisions. I mean they're in the guise of just technical implementation, but they're really policy decisions. I mean if these decisions are going to be made, they should be made by the Government. They shouldn't be made by the CGC. Now, maybe they're the right decisions, maybe they're not, but they shouldn't be the CGC's decisions  
15 to make.

Now, how they're grappling with these questions. Well, I think they're doing the best they can, I guess. But because the system is so complex, there's no right answer to that to your question and we don't know. They might not  
20 even know.

**MS CHESTER:** Do you have any other questions?

25 **MR COPPEL:** I'm good.

**MS CHESTER:** They're all the questions that we had of you for today. Is there anything else that you wanted to say or we haven't touched on that you thought we should have?

30 **DR FITZGERALD:** One leading question. What extent are you looking at the systems in other Federations and seeing to what extent that they could be adapted to our situation?

35 **MS CHESTER:** We did that as comprehensively as we could for the draft report, Vince. I think it's fair to say we probably got more insights of what not to do than what to do.

**DR FITZGERALD:** You don't have to look farther than here.

40 **MS CHESTER:** No, but that said, I mean it comes back to a point, Jerome, I think you made in your opening remarks. The fact that we do it differently and we do full equalisation, doesn't mean that it may be better and I think people say there's lots of other reasons why other international jurisdictions do it differently that are historical reasons. Nobody has ever tried to do it fully  
45 across both sides of the line on one side.

**DR FAHRER:** One final point, we didn't have time to discuss it, but this is



the interaction of direct Commonwealth payments with the CGC process. Right now, they're for the most part counted as State resources and it affects their disabilities. You could certainly make a good case to say that that's not true. The Commonwealth gives money to the States directly to implement Commonwealth policies.

Now, it's not a clean split, as we know, because there's overlapping responsibilities in areas like health and education. But the interaction and the incentives created and there are disincentives that are created. There are incentives created for States not to participate in direct Commonwealth payments and this needs to be looked at carefully as well.

**MR COPPEL:** In our draft report we have an annex looking at those Commonwealth payments and how they interact and the rules that the CGC uses and other agreements. One of the defining features is the extent to which those payments are aimed at achieving some form of national objective policy or other State policy objective.

**DR FAHRER:** The answer is a bit of both.

**MR COPPEL:** In some cases, that's how it works.

**MS CHESTER:** Yes, but is taking it out of a HFE the right lever from what is really a Commonwealth State spending responsibility issue?

**DR FITZGERALD:** It might be better than not taking it out but the factor today is that whatever the Constitution may have said about which level of Government is responsible for the core services that households value most, health, education, welfare, whatever, they are really in the way the public sees them these days, areas of shared responsibilities. So, taking them out altogether might make HFE simpler but it's not quite the reality. It's messy, of course, to know how to treat them if they are regarded as areas of shared responsibility.

The CGC's approach of saying they're all untied money and unless, in the very rare case, the Commonwealth excludes them, isn't the right answer either. It sort of says that this is money the States could do anything with and the fact is they're not able to do anything with it, and in some sense, they shouldn't be able to do anything with it. There should be an agreement between the two levels of Government as to how they share that responsibility. That's not an easy one to get your head around.

**MS CHESTER:** No. Well, on that heart-warming note, we will thank you for joining us today and we will take you up on your kind offer of a couple of the questions we've planted with you. If you could see if you've got any other thoughts that you could come back to us on, that would be really helpful.

**DR FAHRER:** We will send you something in writing, notwithstanding that we've missed the deadline, we'll do it as quickly as we can.

5      **MS CHESTER:** We're happy to take good submissions late. Thank you very much.

**DR FITZGERALD:** My final comment is good luck. There are few knottier areas.

10      **MS CHESTER:** We're going to have a participant join us by teleconference, if the teleconference and IT Gods bestow that great honour upon us, I say looking at Karl and Brad. Folks, go stretch your legs, three minutes, and then we'll see if we can get the IT working. Sorry for those that are next participant cabs off the rank. We're running a little bit behind but we'll get to you as soon  
15      as possible.

**ADJOURNED**

**[11.33 am]**

5 **MS CHESTER:** John, thank you very much for joining us and thank you for your interest in our inquiry. We appreciate that you've been able to do this by teleconference, given that we had enough participants available in Melbourne but not quite there for Sydney, so we thank you for that.

10 I'm Karen Chester, I'm the Deputy Chair, and I'm joined by my colleague, Jonathan Coppel. John, just so you know, we're sort of sitting here in the Melbourne office for the Productivity Commission and you've got about 15 people in the audience listening to what we're about to discuss, so just so you've got a little bit a visual on that. You would be aware that we are taking a transcript. So, a little bit down the track you'll be able to get a copy of the transcript and remind yourself of the discussion that we've had and the evidence that you've given us, so we thank you.

20 John, why don't you just introduce yourself and then maybe if you'd like to run through some brief opening remarks and then we'll get into some questions.

25 **MR McAULEY:** John McAuley is my name. I wish you a good morning. My message to the Commonwealth Grants Commission is simply to give up the impossible task of using HFE to equalise revenue raising capacity and should confine equalisation only to services commonly provided. Now, this would be a substantial and welcome simplification of procedures. You can hear me okay?

30 **MS CHESTER:** Yes.

35 **MR McAULEY:** The Commission, as I say, should forget about revenue raising, trying to equalise that. The Commission already acknowledges that it is able to equalise only about 60 per cent of all State revenue anyway. Furthermore, some of this 60 per cent would have little effect on distributions or has doubtful validity, and therefore, in my view, should be wholly disregarded. Most of the residual would be, in fact, due to Western Australia. That's the big problem.

40 I would summarise the main reasons for ignoring revenue capacity for HFE purposes as follows. HFE principles provide no justification nor precedence for equalising revenue, as I first made the point. There are significant and accidental differences amongst States which inhibit estimates of revenue capacity, especially mining, oil, gas, coal, et cetera, and there are also differing policies on gambling facilities.

45 In some cases, Aborigine communities may have objections or interests in land use. Importantly, I think the main – I think the present system of sharing

revenue acts as a powerful disincentive to investment, despite potential secondary benefit from higher employment, et cetera. My proposal to not equalise revenue would solve the Western Australia problem and it would simplify the Commission's procedures and be reasonably acceptable to the States. It would also enable the year 2000 agreement with the Commonwealth to be maintained. An alternative would be the more radical 2012 proposal of the Brumby Review.

In the year 2015-16, for example, there was only one State, Western Australia, which provided a surplus in total revenue for sharing with other States. This surplus represented an outrageous GST payment by Western Australia out of its GST of nearly \$8 billion for the year. Except for this payment, Western Australia would have qualified to be a \$3 billion recipient of the system, not a net payer. New South Wales and Victoria each have had to pay somewhat more into the system if then there's no HFE on revenue. I would note my view that the Commission has only a rough method of equalising services based on budget dollar costs, I'd say more later perhaps.

I also note my view that the Commonwealth ought to be a formal stakeholder in the year 2000 agreement and accept direct responsibility for deficiencies of its own creations, the Territories of Northern Territory and ACT. Also, that to avoid duplication, there should be closer coordination between GST subsidies compared to Commonwealth payments to and for the States and compared with the various long-term agreements in place for health and transport, et cetera. That concludes my brief summary and my views on HFE.

**MS CHESTER:** Thank you very much, John. Perhaps I might just start with an initial question just so I can make sure I understand what you're suggesting. We do know from looking at international jurisdictions that many just equalise on the revenue or the expenditure side, not many equally fully, let alone on both sides like we do in Australia. Are you saying that the CGC would come up with what the assessed expenses should be as they do currently, based on the average of what States do?

**MR McAULEY:** Would you just repeat that last bit? What was that?

**MS CHESTER:** At the moment, the CGC assesses what the expenditure side of the equation should be for a State, based on the average of what all States do and then adjusting for disabilities, factors like population – well, it's on per capita, so that's population – but remoteness and indigeneity and all the rest of it. Then on the revenue side, they do an assessed revenue position and then they work out what the gap is.

**MR McAULEY:** That's right, yes. They're the two main ones, aren't they? I'm saying that they should forget about trying to equalise revenue and concentrate only on the services, yes.

5 **MS CHESTER:** If they just equalise on the services, so everyone's got their assessed expenses, how do we work out how much needs to be paid to them to meet those expenses if we don't consider their revenue capacity? Otherwise, you'd just be paying them the full amount and the GST pool wouldn't cover it.

10 **MR McAULEY:** They have to just simply pay whatever's required or receive whatever's calculated from the system. If they're a net payer, this would have to be an expense that they'd incur and it would be shown in their budget statement in the usual way. I don't see any point aligning it with revenue capacity. I don't think, in fact, the CGC does that, the Commonwealth Grants Commission. I don't think it really does that. It might claim to or might aim to, but I don't think it does that. In other words, it doesn't ensure that a payee, say, has the ability to pay it. It doesn't do that.

15 **MR COPPEL:** Who would pay? Who would pay for the services delivered?

20 **MR McAULEY:** I'm sorry, but your voice is cutting out. Some of the words have cut out and I haven't heard exactly what you've said.

**MR COPPEL:** The question was who would pay for the delivery of those assessed services provided by the States and Territories, the State or the Commonwealth?

25 **MR McAULEY:** Well, in the first instance I'm talking about not the Commonwealth coming into it. I would say as sort of an aside that my formal statement was that I thought that the Commonwealth should look after Northern Territory and ACT, because it created those two Territories, and if they're not sufficiently financial, it's the Commonwealth that should be picking up the tab, not GST.

**MS CHESTER:** What do you think the GST should be spent on then, John? We've got this \$63 billion a year, what should it spent on?

35 **MR McAULEY:** There's no prescription now, is there, for GST. The States can spend the funds. They're not required to spend it on any special way, like on infrastructure or current expenditure. There's no requirement to do that. Let me not overlook the main point that I'm saying, the equalisation. This is an inquire into HFE, isn't it, which is horizontal fiscal equalisation. That's what your inquiry is about, is it not?

40 **MR COPPEL:** Yes.

45 **MR McAULEY:** I'm now saying that HFE should apply only to services for payment of stage 4 services and there should be no intent to equalise revenue. That's my main thrust.

**MR COPPEL:** Okay. I've just got one more question and it relates to a comment that you made that the current processes used by the CGC act as a disincentive to investment. Can you explain how that works and do you have any concrete examples where that has acted as a disincentive to investment?

5

**MR McAULEY:** I can only say that if I was the Premier or Treasurer of Western Australia and they were paying something like \$8 billion out of their GST and paying it to other States who didn't have any iron ore or gold or other sources of these funds, I'd be inclined to cut back on investment propositions. It may not be a paying proposition for Western Australia to put levies on these products when they have to share most of it with other States. I mean that is the basic problem that you are having to face, I think.

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**MS CHESTER:** John, thank you very much for getting in contact with us and for participating in our public hearings and our inquiry. We don't have any other questions for you, apart from one actually. Before you retired, where were you working as an economist, John?

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**MR McAULEY:** When I was a fulltime employee I was Chief Economist of the State Bank of New South Wales.

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**MS CHESTER:** Okay, great. Thanks, John, it's been really good hearing from you and hearing from some folk from New South Wales. If you could just make sure that you hang up the phone now and we'll let you know when the transcript is up on the website.

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**MR McAULEY:** Okay, all the best.

**MS CHESTER:** Thank you. Can we check that he's hung up, please? Thank you. We're having a public hearing. Terrific. I'll invite the next participant to come up and join us and won't be appearing as God but at the table here, from the Victorian Chamber of Commerce and Industry. So, please come up and join us. Welcome. Thank you for joining us this morning and appearing. If you'd just like to say for the purposes of the transcript your name and which organisation you represent and then if you'd like to make some brief opening remarks.

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**MR HORSFALL:** Certainly.

**MS CHESTER:** Thank you.

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**MR HORSFALL:** I'm Hugh Horsfall, representing the Victorian Chamber of Commerce and Industry and welcome the opportunity to appear at this hearing today. I suppose as Victoria's leading business organisation, we work with and service more than 15,000 businesses each year. Across the State, they encompass all industry sectors and span small, medium, and large size businesses. I suppose when you look at the split of our membership base, it's

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pretty representative of both the industry make up and size of Victorian businesses. I suppose to start with, horizontal fiscal equalisation - - -

**MS CHESTER:** Feel free to say HFE, it's easier.

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**MR HORSFALL:** HFE is grounded in the concept that citizens in different States should have access to equal standards of Government services, recognises that States have different capacities to raise revenue and different spending needs and this is an important principle that is strongly supported by the Victorian Chamber.

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The Victorian Chamber is a key member of the Australian Chamber of Commerce and Industry and we contributed to and support the initial submission that was made by the Australian Chamber to this inquiry in June. That was premised on the key arguments that the Australian Chamber did not find that there was evidence that the current system is detrimental to productivity or provides a disincentive for states to exploit their natural resources, and made the point that HFE should not be looked at in isolation, which I think has been discussed already today, and that proposed changes should be considered in the context of broader productivity enhancing tax reforms and associated reforms to Commonwealth and State financial relations that might address issues of VFI.

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I think it's important to note that as a national organisation the Australian Chamber has looked at all the issues and spoken to its members and not found a significant problem with the way that the GST is currently distributed. The Victorian Chamber has also made a brief submission on the draft report and to speak briefly to the points that we've made there, I'll start with a comment perhaps on the low shares of GST currently being received by WA, which I think are a focus of this inquiry.

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We think this represents the system working as intended. A lower share of GST to WA has been offset by very significant mining revenues. This situation, we think, was foreseeable and if WA's now facing budgetary issues, that is we think more a result of its own budget management and not of underlying problems with HFE or the way that the CGC applies it. I suppose furthermore we're arguing that in the grand scheme of things there are more important issues than the distribution of GST and that the actual amount of money that's redistributed as part of the process is relatively small in the context of the overall revenues of State and Territory governance, although it's obviously bigger for some than it is for others.

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If you look at the distribution of GST in isolation, it's a zero-sum gain. You can't make one State better off without making another worse off. We would rather that Governments focus on broader tax and financial relations reform that can deliver real benefits for business in the community. Maybe just to chime in on the discussion that was happening earlier around

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disincentives for reform, I might comment that a case by case approach that looks at dealing with the issues around specific proposed reforms might be better than I suppose tinkering with the current formula to try and remove disincentives for reform that we're not sure actually exist.

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Victorian Chamber considers that while the current GST distribution methodology is very complex, it's generally working well as intended and should be retained. Given this, we broadly support the recommendations made in the draft report, specifically that further simplification should be explored, that Commonwealth payments to the States should be treated consistently to avoid issues around payments for infrastructure being effectively equalised away, and increasing the burden on one State to fund that infrastructure, without the same treatment being applied to payments to another State.

We're happy with the Commonwealth Grants Commission providing a strong neutral voice in the public debate of HFE, although might argue that I think the people who need to understand HFE in the Commonwealth and State and Territory Governments do. The system is not so complicated or doesn't lack so much transparency that they can't. I think that no amount of additional communication to the public will be able to explain the current approach to the man of the street or person in the street. We're happy with transparency being increased through the publication of data and calculations used by the Commission and, certainly, that Federal and State Governments should work towards longer term reform of Federal financial relations.

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However, we do take issue with and don't support the draft recommendation 2.1, that the system should aim for a reasonable, rather than full equalisation. It seems that this would not contribute to simplicity and would add another arbitrary layer to an already complex system. We would already do everything that we currently do and add another arbitrary adjustment on top of that. Further, we don't support the suggestion that the system equalise to the capacity of the second strongest State. Notwithstanding that it appears that such an approach would significantly disadvantage Victoria, looking at it we don't think there's a clear policy rationale for it as an alternative to the current system.

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To conclude, the distribution of a fixed pool of revenue between the States is always going to be contentious and the Victorian Chamber would prefer that rather than arguing over a zero-sum gain, Governments focus on delivering meaningful tax reforms and reforms to VFI that deliver tangible benefits to business and the community.

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**MS CHESTER:** Okay, great. Thanks very much, Hugh. We might start off first with how we do HFE and you mentioned that the Chamber supports the current way of doing HFE, which was a decision of the CGC, not only Commonwealth, State or Territory Government to do full equalisation to the highest State. Indeed, Victorian Governments of the past have not supported

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that way of doing it. How do you think it grapples with the trade-off then between equity and efficiency? The CGC itself has the objective of equity and they translate that to equality achieving full equalisation to the highest State, but then they've got subsidiary principles which matter for us, because like  
5 yourself, we're very interested in making sure that good decisions are made by States to develop activities and to have good tax bases and have them optimally taxed.

**MR HORSFALL:** I think we have a lot of evidence that we are achieving our equity goals, but I think that the evidence is lacking that we're not achieving  
10 the efficiency goals or that the current system is impeding productivity enhancing reforms.

**MS CHESTER:** I guess the question was the CGC is meant to do that trade-off at the moment.  
15

**MR HORSFALL:** Yes.

**MS CHESTER:** I guess we found in our draft report, and it's only a draft  
20 finding, that if you're going to do full equalisation, it's really hard to get that trade-off. The CGC recently is sort of looking at dealing with that trade-off by making some changes within systems. So, for example, royalty rate increases in WA. They'll get to keep 50 per cent of the royalties, taking CSG out of the equation, similar to gambling. They're already trying to do those trade-offs in  
25 the current system which kind of adds to the complexity. How do you think they're going about grappling with that? I mean they wouldn't be doing those things unless they thought that there were problems from an efficiency perspective?

**MR HORSFALL:** I suppose I think that while it might not be the perfect  
30 system, it is the system that we have and that there are very significant impediments to change, being the zero-sum gain nature of the distribution and the fact that you can't make any State better off without making another State worse off. I suppose I'm comfortable with the CGC continuing to work within  
35 its existing framework to make adjustments that it sees fit and that are contestable by State and Territory Governments through their normal processes.

**MS CHESTER:** I mean the reason I ask the question is I think, if I understood  
40 correctly, you were suggesting that our draft recommendation to move towards equalising to less than the highest, which we do for incentive reasons, you say that's going to make it more complex. Whereas what I'm suggesting to you is the CGC at the moment trying to get the trade-off between equity and efficiency, is making lots of big architectural changes within the system that,  
45 in and of itself, makes it more complex.

**MR HORSFALL:** I think our primary objection to equalising to a different

standard is not the complexity. Complexity is certainly an objection, but - - -

**MS CHESTER:** Sorry, how is it more complex, if it takes pressure off, if it allows the trade-off to occur.

5

**MR HORSFALL:** I suppose I'd take a step back and say that our primary objection to equalising to a different standard is that we don't think that there is a problem with equalising to the current system, and so that moving to equalise to a lower standard seems arbitrary. Then, as a by-product of that, you're doing everything that you currently do and then adding in a separate process.

10

**MR COPPEL:** I think that part is a misunderstanding. What we're suggesting is that there's a different benchmark that's used for equalisation which is less than full equalisation.

15

**MR HORSFALL:** In which case, I would I suppose certainly take the correction that it might improve the simplicity of the calculation but still it would seem to be a change that we don't think is warranted because the current approach is working effectively.

20

**MS CHESTER:** Your main problem then is because you are a fan of tax reform, you don't see that there's disincentives of the current arrangements to tax reform occurring?

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**MR HORSFALL:** We don't see that there are disincentives to tax reform currently occurring and consider for the scale of a really significant sort of tax reform that would involve changes to Commonwealth and State financial arrangements that you could deal with disincentives or issues as they arise, rather than trying to pre-empt them.

30

**MS CHESTER:** The Chamber would be aware of the cameo that we ran for State-based tax reform, a significant one, of halving stamp duty and replacing it with a broad-based land tax on a revenue neutral basis, so not increasing the tax burden on the State. Is that a reform that the Chamber would support? I know economists agree on it but not everyone is an economist.

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**MR HORSFALL:** I suppose we wouldn't be ready to put a position on that here.

40

**MS CHESTER:** Say we were to assume that you thought that that was a good tax reform, the cameo that we ran suggested that if a large State, New South Wales or Victoria, were to contemplate doing so, they would lose hundreds of millions of dollars each year in terms of their GST relativities.

45

I guess that's what took us down the path. I mean we already got it for controversial developments, where if you add another disincentive to that pile,

you're asking for the wrong decision. But with respect to tax reform, we were quite surprised when we ran the cameos that such a disincentive arose.

5 **MR HORSFALL:** Yes. I suppose I'm probably not in a position to comment on the scale of those impacts, other than to say that I understand that the scale of the impacts is contested by the Victorian Government.

10 **MS CHESTER:** They are and we took them to task on that this morning because they've assumed away the reality of no elasticity effects which was quite bizarre, to say the least. Anyway, so I guess what we're saying is if there are these disincentives in the current system and the CGC is trying to get full equalisation, I'm just trying to grapple with if we feel there is an impact on – so, if there is an impact on the real economy, i.e. it is holding States back from doing such tax reforms, that would kind of seem to align with the position of  
15 the Chamber, wouldn't it, in terms of you want good State tax reform, you want economic growth and you want jobs, and I guess we sort of share that objective.

20 **MR HORSFALL:** Yes, I would agree.

**MS CHESTER:** I guess I'm struggling then as to why you would oppose the change, if we've run a cameo that shows that such a significant reform by a State or Territory Government – well, State Government moving first, there is such a current disincentive in the current system, because we've moved so far  
25 away with an outlier from equal per capita.

**MR HORSFALL:** I suppose it's difficult to say without being right across the detail, but while the extent of disincentives for a reform are contested, I suppose the Victorian Chamber is not in a position to support this particular  
30 change which would result in seemingly a big financial hit for Victoria.

**MS CHESTER:** On the financial hit to Victoria, it really becomes a transition path issue. The first few years, if we were to go cold turkey, there would be a big hit. We're still looking at these numbers to test their veracity, but indeed,  
35 some numbers that have been provided to us by one State suggest that Victoria ends up being a big net winner. I guess that's why in the past, apart from this Government, previous Victorian State Governments have been supportive of reform of HFE, indeed moving further than we've suggested, even going to EPC, because Victoria was a net winner.

40 **MR HORSFALL:** Victoria certainly has argued for an EPC distribution in the past but I think the big barrier to that is where would the money for the top ups that would be required for the losing States, where would that come from. In the absence of that, it's hard to see how moving to an EPC distribution is a  
45 realistic option.

**MS CHESTER:** Well, we're not recommending that. I guess what I'm trying

to understand is you're arguing don't make this change because it hurts Victoria. I guess what I'm suggesting is medium to longer term it doesn't hurt Victoria. So, doesn't it then just become a transition issue?

5     **MR HORSFALL:** I suppose you're unpicking our reasoning, which is good, but I would clarify that we're saying don't make the change because we don't have a problem with the current approach. We are also saying don't make the change if it makes things more complicated, which perhaps it doesn't. A third point would be don't make the change because it appears to have a big financial  
10     impact on Victoria. I suppose if the States and Territories can agree on the rationale for change and on the financial impacts and a transition path, we would certainly be able to look at it again, but I think on the current evidence and on the current information, we don't have that sort of consensus yet.

15     **MR COPPEL:** Can I just pick up then in one of the comments you made on the draft report where we suggested further scope for simplification should be examined.

20     **MR HORSFALL:** Yes.

**MR COPPEL:** You've supported that. Do you have any specific areas where you think that simplification could be achieved?

25     **MR HORSFALL:** No, I don't. I suppose the in-principle comment that the system is extremely complex and that if you can achieve similar outcomes with fewer inputs and get everyone to agree on it, which I understand in the past have been very difficult, CGC should absolutely pursue those options.

30     **MR COPPEL:** I guess it's a general comment and it's not just with your presentation, but when we're speaking about a transition, the focus is always on fiscal impact vis-à-vis the current arrangements. The case that we're trying to make in the draft report is that fiscal impact is one consideration but really, it's a formal policy cost benefit analysis.

35             Can you improve on predictability of stability of the system? Can you give a greater weight to the trade-offs that are made between equalisation and efficiency trade-offs? It's really those other considerations, those other attributes that we see as objectives of policy reform. But the focus is always on what is the fiscal impact today, and I was wondering whether you had any  
40     comment on our goal to achieve some of these other policy attributes which we see as positive ones?

45     **MR HORSFALL:** I certainly support the goal and maybe referencing back to the previous discussion, I think part of the problem is that that goal is not best pursued by looking at HFE in isolation, that that goal is better pursued in the context of a broader discussion around tax reform, reform of Commonwealth State payments to alleviate VFI, as part of a broader

discussion.

5 **MS CHESTER:** Just so we're careful we don't mischaracterise the earlier commentary, it was saying that, as we do in our draft report, longer term, there's only so much you can do with HFE today in isolation.

**MR HORSFALL:** Yes.

10 **MS CHESTER:** Of longer term, looking at VFI and Commonwealth State spending responsibilities as part of the Federal financial reform. I think we can all agree on that.

**MR HORSFALL:** Yes, certainly agree with the objectives.

15 **MS CHESTER:** I'll just be careful we don't mischaracterise the earlier participants, because they actually did say reforming the current HFE arrangements did offer a path and a benefit to the economy in the interim. Anyway, I just want to make sure we don't mischaracterise.

20 **MR HORSFALL:** Yes, certainly.

25 **MS CHESTER:** Then if we are to fast forward the clock and we've Commonwealth and States prepared to dare greatly and reform VFI and reform responsibilities for expenditure, what sort of change do you think that would mean for Victoria. What taxing powers do you think Victoria would have. What responsibilities would go back to Commonwealth? What would stay with Victoria, and then what would HFE look like in that new world?

30 **MR HORSFALL:** I suppose that's a very big question. I would probably say that HFE should be a secondary consideration or should be something that falls out of the primary parts of the reform, rather than be a driver of it.

35 **MS CHESTER:** Yes, and I think that's right, because when you look at the CGC's post-draft report submission to us, and when you go through the steps – you know how we've got the little simple equalise to the average, equalise to the highest and then the top up over the top.

**MR HORSFALL:** Yes.

40 **MS CHESTER:** When you actually even look at that, even WA with its bounty at the moment, when we equalise to the highest, which is WA's fiscal capacity, WA still can't meet its assessed expenses because of VFI. So, to some extent the HFE task will be much lesser for larger States.

45 **MR HORSFALL:** Yes.

**MS CHESTER:** Or those more fiscally capable States, than it would be. So,

we then get to a point maybe of just dealing with the smaller, fiscally weaker States, that are structurally fiscal weaker.

5 **MR HORSFALL:** I suppose that brings you back to some of the arguments that have been had in previous years around equal per capita for the large States with top up payments to smaller States and some of the options that have been looked at before.

10 **MS CHESTER:** If we can deal with the transition path, could I suggest to you that moving to equalisation to the average or equalising to the second highest, is actually part of the path to getting to that longer term?

15 **MR HORSFALL:** I think it could be. It could be, but the nature of the current system means that you need to get agreement on that change to get there.

20 **MS CHESTER:** Well, we wouldn't be recommending anything to Government if that was something we took into account all the time when we make recommendations. Given the Chamber's view on the importance of tax reform, and we're thinking of other cameos that we might run to see what happens to your GST relativities if you dare greatly, what are some State-based tax reforms that the Chamber would like to see?

25 **MR HORSFALL:** I suppose the sorts of tax reforms that we currently focus on or advocate for are more within your adjustments to rates and thresholds and, in particular, on payroll tax.

**MS CHESTER:** So what, broadening the base and lowering the rate, or more exemptions? I'm just trying to work out how reformist the Chamber is.

30 **MR HORSFALL:** I suppose what we're saying on broader tax reforms is we want to have those conversations and we would like that to be part of a sort of better functioning relationship between the Commonwealth and the States, where they can talk about broader tax reforms without some of the brinkmanship that currently occurs, and have that conversation without  
35 advocating for specific swaps or specific changes.

40 **MS CHESTER:** There's nothing on the Chamber's shopping list where you want the State Government to change the way it taxes certain revenue bases at the moment?

**MR HORSFALL:** The current position on payroll tax is on raising the payroll tax threshold to reduce the impact on smaller businesses.

45 **MS CHESTER:** We might have to agree to disagree then on whether that's reformist or not.

**MR HORSFALL:** Yes, happy to do that.

**MS CHESTER:** Did you have any other questions, Jonathan?

**MR COPPEL:** I haven't got anything, no.

5 **MS CHESTER:** We are done.

**MR HORSFALL:** Yes, thank you very much.

10 **MS CHESTER:** Is there anything else you wanted to say, Hugh, that we haven't covered off in our questions?

**MR HORSFALL:** No, that's good.

15 **MS CHESTER:** Terrific. Thank you for appearing today; we appreciate it.

**MR HORSFALL:** Thank you.

20 **MS CHESTER:** If you do happen to think of any other tax reforms, let us know. We're looking for more cameos.

**MR HORSFALL:** Certainly.

25 **MS CHESTER:** Terrific. Thanks, Hugh.

**MR HORSFALL:** Thanks.

30 **MS CHESTER:** I'd like to ask our last participant, and sorry we're running so far over, to come and join us, from the Victorian Trades Hall Council.

**MS BOSLER:** Thank you.

35 **MS CHESTER:** Welcome. You probably have an idea of where we might go with the questions.

**MS BOSLER:** I do.

40 **MS CHESTER:** So, you're well prepared. For the purposes of the transcript, if you wouldn't mind just by stating your name and the organisation you represent, just for voice recognition, and then if you'd like to make some brief opening remarks.

45 **MS BOSLER:** Yes. We'll keep it brief. My name's Danae Bosler. I'm the politics and research lead at Trades Hall, and I'm also supported by Ted Sussex, our research organiser at Trades Hall as well.

**MS CHESTER:** Sorry, Ted, can you just - - -

**MR SUSSEX:** Yes, sure. Ted Sussex, research organiser, Victorian Trades Hall Council.

5 **MS CHESTER:** Thank you, just so they don't misattribute you to Jonathan which could be very problematic.

**MS BOSLER:** For the tone, yes.

10 **MS CHESTER:** Yes, for voice.

**MS BOSLER:** Yes. Thank you very much for hearing us today. I'll just do a brief introduction. Victorian Trades Hall Council is the peak body for unions in Victoria. We represent 41 unions in Victoria and over 430,000 union members. Those union members cover every industry in the State, both the public and the private sectors, and VTH and its affiliated unions have campaigned and won on a range of important rights and entitlements for Victorian workers, everything from the 8-hour day, through to health and safety.

20 Our appearance today is probably a little out of the ordinary, you might think. We're not economists, which might be refreshing for you, but we wanted to represent – no offence to the economists – representing the interests of Victorian workers in what is a genuinely, we would argue, complex issue, but we feel that the impact will be most felt by workers and by Victorian workers.

25 Our short submission is in support of what we think has been excellent advocacy work of the Victorian State Government to represent our State at a national level. I'll abbreviate HFE with your forgiveness, if that's okay. I guess we should start by putting on the record, we wouldn't be here without first making a comment about we've long held a view of opposition to the GST as we consider it a regressive tax that disproportionately impacts on our poorest. To speak to particularly your draft report and to what you'd like to discuss today, we have three brief comments, and that is that the objectives of the HFE are sound.

30 VTHC joins with others, and it's awkward to agree with Becky sometimes, but we agree with many others who have spoken to this in a more in-depth way than we can. VTHC advocates reposition of raising up all States to be equal. This is a principle we take to our industrial relations framework, for example, and we would argue that there is also little indication that the objectives of the HFE actually need to be changed.

40 We would see good policy. We argue that, not just because we're obviously going to talk about what would be the impact on Victoria and the detrimental impact on Victoria, but also good policy should be based, not just



on economic outcomes at any given time, but on the principles and the values that rest behind that policy decision that's being made. We support good, sound, steady, predictable, reasonably economic management and a change to HFE, we argue, would not be that right now.

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Number 2, our State at this point in time, which is what you've kind of alluded to, and some other States, but we'll focus on Victoria, as a result of some of your proposed changes would be huge and cannot be underestimated. I think some other folks talked about the redistribution and the numbers would actually not be that great, but we argue that it would be huge.

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Your draft report talks about significant disadvantage during a transition period and I'm sure that the Commissioners have seen the raw figures of about \$970 million out of Victoria and what that looks like for Victorian workers. We constantly feel the pressure of cuts and cuts to the public service and to public sector and cuts to public infrastructure. That translates for us into 3900 teachers, into 7700 police, into 8700 nurses or into 150 velocity train carriages.

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Even during a transition period, we think the impact that would be felt by Victoria is just too great. We support excellent public infrastructure programs of the current Government. We don't want to see anything that would limit or hamper that.

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We also support the commitment of this State Government to quality public services and we don't want to see anything that would hamper that. There is no role more central to Government than the provision of public services and infrastructure and time after time again, surveying of our members just shows jobs, health and education. That's it, time and time again for our members, as the most important thing. I think the final point I'd make which hasn't really been discussed at much but I'm always keen to discuss is the further attempts and efforts that need to be made to make economics and topics of this nature more accessible for workers and for their communities.

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There were some recommendations in there but the recommendations of this inquiry would have a huge impact on Victorian workers and I'm happy to talk further about some of the ideas about how we can make it more easily accessible for workers to participate in these sorts of conversations.

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**MS CHESTER:** Great. Thank you very much. On your last point of accessible, that's something that we try to work harder at. Our recent five-year productivity review, which we tried to make a very accessible and digestible read, i.e. we banned the team. There was a swear jar if you had techno jargon in there. But it's not easy and, indeed, in this whole world of HFE where even a lot of State officials did not understand the way the CGC does it. We had to explain to one jurisdiction that they do equalise to the highest. They weren't aware of that. So, we know we're sort of up against it and all feedback gratefully received on how we can do that better going forward and maybe we can have a chat separately. Just coming back though to the objectives of HFE

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and I guess people have sort of used, interchangeably, the term “equality” with equity.

**MS BOSLER:** Yes.

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**MS CHESTER:** I think there’s an important distinction to be made, in my thinking, but I’d be interested in your thinking of what the distinction is between equality and equity?

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**MS BOSLER:** I would interpret equality as, and I can bring a gender lens to this and a whole bunch of other things as the inputs, but the equity is the outcome. We should come out as equals. Is that the shortest way to short of summarise it? Is it the end point that we end up at? We should come out on a level playing field as equals, and if that means that you, who have the capacity to contribute more, has to contribute more so that I can stand at the same height as you, that’s the equal outcome that I seek.

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**MS CHESTER:** Yes.

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**MS BOSLER:** I’m putting on to it very - - -

**MS CHESTER:** No, and it’s good to see it through different lenses. I guess here in this area of fiscal capacity, equality means everyone’s the same, whereas equity might have two streams. One is what would be fair to make sure that people have a fiscal capacity that’s not too different from others, such that a worker in Northern Territory should be able to get the same level of services in Darwin as a worker in Melbourne.

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**MS BOSLER:** Yes.

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**MS CHESTER:** That’s kind of what I think HFE is meant to be about.

**MS BOSLER:** Yes.

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**MS CHESTER:** That’s one strand of it. At the moment, the fiscal capacity is to do it the same takes you to the highest, but even the highest doesn’t get you to your assessed expenses. I’ll come back to that in a moment.

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The other side to equity is what’s kind of fair – so, that’s about the individual. The other side of equity is what’s fair to a State or Territory Government, particularly when they make effort, where they implement a tax reform that’s politically difficult, where they undertake a development activity that’s politically difficult but they do it because they think it will be better for economic growth and for jobs. There’s kind of these two lenses of equity when you think about the impact of HFE and how it’s being implemented. The reason I touch on that is because I guess that’s partly our motivation and indeed our Terms of Reference asked us to say what’s the impact on the real economy.

45

There's two strands there. One, and what's been focused on historically, is about is HFE making sure that interstate migration is not being motivated by different fiscal capacities. We found, yes, that's not a problem.

5           The other aspect though is what impact it has on the incentives of State and Territory Governments to undertake development activities and to do tax reforms and that for us is where you can connect the dots to the equity side. There is this little overlap between equity and efficiency, where having an efficient outcome, like a better tax base for Victorians that raises revenue more  
10           efficiently, that doesn't distort the economy and it's better for economic growth and productivity and jobs. That's the territory that we're in and it's not an easy territory because there's not a lot of evidence, so we went to cameos.

15           I know the cameos are disputed. I think the evidence is there on the development side but on the tax reform side, if we are right and our cameos are right and they are an obstacle to States undertaking tax reform, can you kind of see the link that there could be to an equity outcome?

20           **MS BOSLER:** Yes. I guess I'd make two comments which is firstly that I'm always cautious about talking about tax reform because usually the first thing that companies go yelling and screaming is that they need further tax reforms, and we'd argue that tax serves as a very - - -

25           **MS CHESTER:** I know. People use the term "tax reform".

**MS BOSLER:** Yes, it's used as a term for things that we disagree with.

**MS CHESTER:** Yes.

30           **MS BOSLER:** Then the second comment I'd make which is back to your first comment, is that if we are forcing – is that the best method to drive – is it forcing State Governments to have to come up with initiatives or, you've said, politically uneasy or politically not popular development strategies? Is that  
35           more of a stick than a carrot, if you're going to force us to have to go through these because this restructure might mean that we are going to have a gap of \$907 million and that will force us to go seeking out. I don't want to be forced to seek out issues.

40           **MS CHESTER:** No, no, no. It's more just to make sure that if a State wants to do something that's politically tougher that they think is in the best economic interests of the State, be it a tax reform or a development activity, that there's not a disincentive that it's going to cost them GST relativities.

45           **MS BOSLER:** I would like to see an example. I'd have to take it on notice I'd like to see an example of what is – I would like to argue that any tax reform or initiative to make the State stronger would not be politically unpopular. We would argue that if it's going to make the State stronger, it wouldn't be – if

something's politically unpopular and, for example, we're opposed to it, we would argue that it's probably because it's not going to make the State stronger and make the State better, a stronger economy, or do you want me to take that on notice?

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**MS CHESTER:** No, maybe take it on notice, but I think there's lots of good policy changes that we would like to see and, indeed, your State Treasurer would like to see. But he, himself, said they're just politically difficult, and we know that. Say, for example, reforming halving stamp duty and putting a  
10 broad-based land tax which actually is very – from your perspective of equity, is actually a good tax policy change.

**MS BOSLER:** Yes.

15 **MS CHESTER:** It is really politically difficult, and the cameo that we ran suggested for a large State they're going to get whacked \$700 million to a billion dollars annually in loss in GST relativities by doing that. So, that's where we're coming from when we're saying we think the way we're currently equalising could be having this impact on the real economy.

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**MS BOSLER:** Yes.

**MS CHESTER:** Anyway, I know this is a bit more conversational than it probably should be. So, have a think about it.

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**MS BOSLER:** Yes.

**MS CHESTER:** What would be good to know is at the State level, what tax changes the Council would be interested in, and for us to have a think about  
30 whether or not the HFE system is a betablocker or not. Just on the transition path issue, and I know everybody's focused on the big numbers, indeed, when I saw the Herald Sun this morning. Indeed, our report goes to great lengths to say we would never recommend or suggest an immediate cold turkey change. Indeed, it would need to be transitioned over an extensive period of time, given  
35 the broad relativities we've got at the moment. So, nobody from the Commission is ever suggesting that a State Government would be down \$1 billion the next day. That makes us then think about if we do think there's this impact on the real economy and we do want to transition to equalising to something less than the highest, what would be the principles that might guide  
40 the transition path.

**MS BOSLER:** I'd first preference it and start by saying even a transition process, we still go back to the number one claim about let's go back to the principles of why are we even changing the system. Putting that aside, why  
45 are we - - -

**MS CHESTER:** Assume I've convinced you but I won't, but assume we

have. If we were looking to do it - - -

**MS BOSLER:** Yes, what principles can we apply.

5 **MS CHESTER:** What principles do you think we should be applying?

10 **MS BOSLER:** The normal principles that we would say in any sort of downsizing or cut of public funding, because that's what it's going to be, a cut of public funding to Victoria, you have to protect frontline services and you have to protect frontline jobs. So, we'd never support any cut of public funding, but if that's the path we're going to go, if we're going to be forced through that transition path, how do we protect services, frontline services, and how do we protect as many jobs as we possibly can?

15 **MS CHESTER:** It might help you, and we haven't tested the veracity of the numbers, but we did get from the WA Government a transition path out to 2026-27, which would suggest that the first three years there's no impact on Victoria, the fourth year -26 million, the next year -8, and then your +100, +230, +413.

20 **MS BOSLER:** I think the Treasurer also probably alluded to this this morning as well, is that historically Victoria has always been more of a contributor than a benefiter from this process. That comes back again to the principles that we had at the start, is that we contribute when it's our turn to contribute, and when  
25 it's our turn to be on the receiving end, that's the way the principles are bedded down.

**MS CHESTER:** No, and indeed unless we all move to equal per capita.

30 **MS BOSLER:** Yes.

**MS CHESTER:** We say it in our draft report, that that isn't HFE in any way, shape or form.

35 **MS BOSLER:** Yes.

40 **MS CHESTER:** One other thing and the penny only dropped when we saw the CGC's post-draft report submission, and we started looking at assessed expenses, so under HFE at the moment there's sort of assessed revenues and assessed expenses and then we do the equalisation dance to get people to be able to meet their assessed expenses. That's making them able to. When you actually look at what Victoria's actually spent, so focusing on outcomes, it's actually less than the assessed expenses for those categories, and they've done that over the last six years. So, to some extent, we're equalising to a highest  
45 to give the States capacity but they have autonomy, so some of them will and some of them won't meet those assessed expenses.

When you look at the relative order or magnitude of how much they haven't spent, it's not that dissimilar to the order of magnitude of what changes might be over the longer term for the changes for Victoria, in terms of - was it 1 to 1.2 per cent of all State revenues, if we were to implement moving to equalisation at the average immediately.

**MS BOSLER:** Are you saying they're not using all of our money? Is that kind of what you're suggesting, and not using - - -

**MS CHESTER:** I'm just saying everybody's saying you're going to be depriving us of how many numbers of State jobs and I'm saying, "Well, I look at what's currently being spent from what you're getting and you're not spending it at the moment anyway, and it's within the bounds of what you're not spending is what we'll be proposing if we were to do it immediately". I'm kind of just a little careful when people talk about big numbers and they're repeated by other people of what job losses might be. It's not necessarily the case if we were to transition, let alone if we were to do it, that equalising to anything less than the highest would actually result in the outcome of less being spent on those services.

**MS BOSLER:** Yes, I'm not going to challenge or question how our Treasurer is going about balancing the budget and choosing to leave – and balancing it out there.

**MS CHESTER:** But you're happy to use his numbers and quote what job losses might be.

**MS BOSLER:** Yes, for fear this will be a possible outcome and if they say, if the Treasury and if the Department says we will feel pressured to or we will feel this is a possible threat that could come our way, and this is a threat that we've experienced at a Federal level many times before, then we're happy to come to that defence of the decisions that the Treasurer's made.

**MS CHESTER:** Okay. I think it would be helpful if you're going to defend people, have a look at the CGC post-draft report submission and actually have a look at what happens, because we're talking about fiscal capacity and the ability to. We're not talking about outcomes here. I guess we're trying to make sure there's an informed debate about what would be the implications for real people of any of the recommendations that we make.

**MS BOSLER:** Yes.

**MR COPPEL:** That difference would be either spent on other areas that are not in the assessed expenditure or it could be running a budget surplus. Can I just ask you one question? We've heard a lot about the role that State Governments play in HFE, much less so on the role that the Commonwealth Government plays. It has probably withdrawn over the years from the debates

that happen, particularly when you've got this period of more extreme dispersion of relativities. I was wondering whether you had any views on what role the Commonwealth should be playing in the area of HFE, what different role?

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**MS BOSLER:** I'd have to take that one on notice as well about what more of a stronger leadership role you think the Commonwealth should take. I hadn't thought about it. I've been focusing on State.

10 **MS CHESTER:** Given your focus is at the State level and we don't expect you to be an expert. We don't expect anybody to be an expert on this stuff because it's so horribly complex.

**MS BOSLER:** Yes.

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**MS CHESTER:** I still claim there's only 30 people in Australia that truly understand how this thing works. There's also HFE occurring within State Governments for their Councils. I don't know if you're aware of that because there is kind of like a vertical fiscal imbalance between State and Local Councils and particularly for those less fortunate, those in more difficult regions with less capacity to raise - - -

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**MS BOSLER:** Smaller, remote rule.

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**MS CHESTER:** Yes, yes, yes. It's kind of interesting when you look at that. State Governments don't equalise to the highest. They don't even equalise to the second highest. They don't even equalise to the average. It would be good to get your sense of – there seems to be an asymmetry here in terms of the way they implement HFE themselves within their own State borders.

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**MS BOSLER:** That's another question where I'm going to have to - - -

**MS CHESTER:** I know and I'm only asking it now because I wish I'd asked it this morning when the Treasurer was here and I forgot to.

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**MS BOSLER:** I'm happy to go and talk to the Australian Services Union, the union that covers local council, and take their – because obviously Local Councils are also under a rate cut pressure right now, which is the focus of what the ASU is concerned about, but I'm happy to go and ask the ASU for their feedback on that position too.

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**MS CHESTER:** I am conscious from other inquiries that a lot more responsibilities are being pushed out to Councils and there seems to be a bit of an asymmetry on what principles are applied. I didn't have any other questions. Did you, Jonathan?

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**MR COPPEL:** No, thank you.

**MS CHESTER:** Is there anything else you wanted to say that we haven't covered through the Q and A and your opening remarks?

5 **MS BOSLER:** No, I think we're all covered. We're happy to provide a follow-up one pager.

**MS CHESTER:** If there's any kind of State-level tax reforms that the Hall supports, let us know.

10 **MS BOSLER:** Yes.

**MS CHESTER:** That would be great. Thank you very much for appearing today.

15 **MS BOSLER:** Thank you.

**MR COPPEL:** Thank you.

20 **MS CHESTER:** We are 40 minutes late but it's been a very good session this morning. We thank the participants and I now call our Melbourne hearings to a close. We will resume next Tuesday in Adelaide, if I'm correct, and I'm looking at my team to tell me that's correct. They're nodding, yes. Thank you very much everybody.

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**MATTER ADJOURNED AT 12.41 PM UNTIL  
TUESDAY, 21 NOVEMBER 2017 AT 9.00 AM**