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SELECT COMMITTEE ON STATE GOVERNMENT FINANCIAL
MANAGEMENT

**Reference: Commonwealth, state and territory fiscal relations and state and terri-
tory government financial management**

THURSDAY, 24 JULY 2008

SYDNEY

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**SENATE SELECT COMMITTEE ON
STATE GOVERNMENT FINANCIAL MANAGEMENT**

Thursday, 24 July 2008

Members: Senator Ian Macdonald (*Chair*), Senators Boyce, Bushby, Forshaw and Polley

Participating members: Senators Abetz, Adams, Arbib, Barnett, Bernardi, Bilyk, Birmingham, Mark Bishop, Boswell, Brandis, Bob Brown, Carol Brown, Cameron, Cash, Colbeck, Jacinta Collins, Coonan, Cormann, Crossin, Eggleston, Ellison, Farrell, Feeney, Fielding, Fierravanti-Wells, Fifield, Fisher, Furner, Heffernan, Hogg, Humphries, Hurley, Hutchins, Johnston, Joyce, Kroger, Lundy, McEwen, McGauran, McLucas, Marshall, Mason, Milne, Minchin, Moore, Nash, O'Brien, Parry, Payne, Pratt, Ronaldson, Ryan, Scullion, Siewert, Stephens, Sterle, Troeth, Trood, Williams, Wortley and Xenophon

Senators in attendance: Senators Boyce, Bushby, Forshaw, Ian Macdonald and Polley

Terms of reference for the inquiry:

To inquire into and report on:

Commonwealth and state and territory fiscal relations and state and territory government financial management, including:

- a. Commonwealth funding to the states and territories – historic, current and projected;
- b. the cash and fiscal budgetary positions of state and territory governments – historic, current and projected;
- c. the level of debt of state/territory government businesses and utilities – historic, current and projected;
- d. the level of borrowing by state/territory governments – historic, current and projected;
- e. an examination of state/territory net government debt and its projected level – historic, current and projected;
- f. the reasons for any government debt including an analysis of the level and efficiency of revenue and spending;
- g. the level of investment in infrastructure and state-owned utilities by state and territory governments;
- h. the effect of dividends paid by state-owned utilities on their ability to invest;
- i. present and future ownership structures of current and former state-owned utilities and the impact of ownership on investment capacity; and
- j. the effect of investment by state-owned utilities on Australia's capacity constraints.

WITNESSES

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Committee met at 9.08 am**BAIRD, Mr Michael Bruce, Member for Manly, New South Wales Parliament**

CHAIR—Colleagues and ladies and gentlemen, I declare open this sixth public hearing of the Senate Select Committee on State Government Financial Management. The committee was established earlier this year to inquire into the fiscal relationship between the Commonwealth and the states and territories, as well as to look at state and territory financial management. We have so far received 43 submissions for the inquiry and they have all been authorised for publication and are available on the committee's website. These are public proceedings, although if any witnesses are interested in giving evidence in camera they should indicate that and the committee will consider it.

This committee is a committee of parliament and parliamentary privilege applies. As Mr Baird will know—others may not—it is unlawful for anyone to threaten or disadvantage a witness on account of the evidence given to the committee and any action may be treated by the Senate as a contempt. Normal rules of committee procedures apply.

I now welcome the New South Wales shadow minister for finance Mr Mike Baird, a name well known to all of us in the federal parliamentary arena. It is good to have you with us, Mr Baird. I understand the submission is a joint one between yourself and the shadow Treasurer, who was unavailable, and at reasonably short notice you have come along to join us, so thanks very much for your time. I am conscious that you have to leave by about 20 to 10, so we will try to keep our questions to that timetable. I invite you to make a short opening address, if you would like to, and then we will ask you some questions.

Mr Baird—Thank you for the opportunity to speak, and I bring the apologies of the shadow Treasurer, who was instrumental in this submission and has done, I think, a very good job. I will attempt to pick up a couple of his key points and themes and, at the same time, engage in some discussion as we go along. I do not want to repeat the submission, but I do want to highlight a few of the salient points.

The first port of call is the recent revelation that New South Wales will acquire extra baseload electricity capacity by 2013 and 2014. We have had this sudden realisation that we cannot fund that sort of investment without putting the state's AAA credit rating at risk. So the question is: do we in New South Wales really have an understanding of the true state of the New South Wales budget and, indeed, the real risks we are facing? If you look at electricity in the preceding budgets over the past decade, there has been neither explicit detail nor any real indication of the problems that have been brought home to us by the Owen report.

The Owen report talks about a shortage or mismatch between supply and demand in this state which will arrive in 2013-14. That is not an event that has come about without warning or without proper analysis or understanding of Treasury or government, you can assume, yet until the Owen report arrived the public had no idea whatsoever. It is not just a startling revelation; it also has significant financial consequences. The financial bill, according to the Owen report, is up to \$14 billion—that is, \$8 billion which is required for a new generator to start to provide increased supply to meet the rising demand; \$2 billion to \$3 billion to bring the retailers into alignment with the changing and dynamic industry, so they would have to horizontally amend

their business models; and \$2 billion to \$3 billion to retrofit the generators. That is a \$14 billion bill that we had no understanding of.

That raises questions about how these assets have been managed. What is the asset quality? What are the real risks? What exposure do we really have? With the carbon trading scheme, which has been forecast for a considerable period of time, there is a late realisation that this is not only reducing the value of the assets but also potentially exposing the people of New South Wales to significant commercial costs that they were not aware of. The commercial risks come in the form of exposure through coal contracts and electricity hedging contracts on which, while released in the individual agency annual reports, there is scant detail on strategic financial intent. That is really the first point.

We also want to comment on the lack of accountability, which is a theme that we want to push forward. The current state government's inability to manage and contain expenses growth—which I will touch on in a minute—is really, to us, the beacon of that lack of accountability. There is a question about reporting and whether there should be some ownership or role for the federal government in terms of keeping accountability for ongoing budget discipline. We do not think that is something that should be allowed to go unchecked, and certainly the question of GST payments should be looked at in the light of actual accountability in relation to maintaining expenses at forecast levels or ongoing expense control, as any sort of normal corporation would. We would encourage that.

In terms of the state budget results, these have been consistently sustained by unforeseen windfall tax revenues. In that context, poor budgeting leads to poor results. It is ongoing. If there is significant capital coming into the state but then there is an economic downturn, that inevitably leads to a lack of accountability and an ill-disciplined approach to financial management, because projects that are devised with surplus funds at short notice are invariably without strategic intent, and we certainly think that is something we should look at.

The decision by the current New South Wales government in the last two years to greatly increase debt to fund infrastructure backlog has opened up the government to cost-induced shocks. The state government has put together quite detailed legislative fiscal targets, which we have included in the submission. Yet whilst the political demands have now come to fruition—the state is looking very much for improved service delivery of infrastructure that has been planned and certainly has not eventuated over the past 10 years—in terms of financial impacts, we have now been opened up to cost-induced shocks, which have increased debt, and the capacity to absorb economic shocks—and I think this is a very important point—has been greatly diminished as we pursue this rapid increase in debt.

If we are ignoring legislated fiscal targets to pursue debt-led strategies, there has to be a question of whether we are in a position to be able to absorb the shocks. Certainly the current market conditions you read about in the paper—and my market contacts say this—are the worst we have seen in 20 years; in fact, there is a view that there is worse to come. In that context of politically induced, debt-led strategies against a backdrop of potential huge economic shocks, the question is: where is the accountability in relation to that?

The last point is one of budget transparency. We make the point here that this is a huge issue for everyone that tries to understand what is going on with the state budget. Whether it be

changing accounting standards or ongoing reporting formats, or lack of details in relation to key infrastructure projects, and whether they be politically motivated, it is very difficult to understand the true state of the budget and, indeed, the true potential of the risks that we are facing. So budget transparency is something that we would ask to be closely looked at and we would certainly support any uniform approach to ensure that day in, day out there is a very clear understanding of the numbers that you are looking at today; how they relate to the numbers previously and, importantly, the key projects or the key risks; also to look at electricity and how that is reported in a very clear way.

Another important point is private trading enterprises. We certainly have no comfort in management independence and it is a very difficult nexus to look at because, whether it be the risk of the individual PTEs, whether it be the requirement for future investments or the short-term budget needs of state governments, it is a very difficult line that is drawn. We cannot get the comfort that indeed they are independent, if you look at some of the facts.

Using Country Energy as an example, which control a large part of the electricity grid, six or seven years ago there was an increase in debt. There was \$2 billion transferred in debt into the PTE, which obviously was not increased investment, which the Owen report has now identified is urgently required. So if that \$2 billion was borrowed on the PTE and actually invested six or seven years ago, then the arguments for privatisation start to reduce, the financial impacts and consequences start to reduce, and we think that is a very real point.

The argument might have been one of WACC—weighted average cost of capital—that the grid was undergeared relative to comparable companies, both around Australian and globally—but the point is that surely a PTE has to take responsibility for the long-term strategic intent of that business, rather than just be a whim of another source of revenue outside of the budget for the government.

The question of Sydney Water has to be put into that as well. They have paid a huge range of dividends and taxes over the past 10 to 15 years, yet all of a sudden there is a change in strategic direction. We have got a desalination plant and that has come at a significant cost to the consumer, amongst all the current pricing shocks. If there is independence in relation to the PTEs and they are managing both their short-term and long-term risks, as opposed to short-term political cycles, there would be a very different approach to the management of these entities.

You cannot help but look at the electoral cycle of dividends. In 2003 there was a peak in the dividends in that election cycle, 2003 being the election. There was \$768 million paid to the state government in dividends. In 2007 that rises to again another peak of \$1.1 billion and, in the forecast estimates the next peak, not surprisingly, is 2011, being \$1.4 billion. So the dividends are at their highest level at the point of each state election. The PTEs is an issue that we do not take lightly and we certainly think that the committee should look at them in terms of the overall management of a state government.

We also raise the point again—and it comes back to accountability—of supporting unsustainable management practices. The Stokes and Vertigan report, which is referred to in the submission, talks about revenue rising at five per cent over a 10-year period, but expenses rising at six per cent, and that gap has gone on at the cost of close to \$400 million a year. In relation to some of the expense rises we have seen—and the total expenses have gone from \$36 billion to

\$45 billion—the employee expenses have gone up at the highest rate, from \$18 billion to almost \$23 billion. The important point there is that those rises have grown at a much faster rate than the private sector.

There has to be some sense of accountability for managing these expenses. Unless there is, you have a position where the government is going backwards, under the current numbers, at about \$400 million a year, yet there is no account for ongoing management and delivery of services, and that is a significant problem.

I will raise the point of unfunded super, which is only touched on very briefly in the submission but it is a pertinent point, because the approach of the state government to dealing with this is really very open to manipulation. They have addressed it in this year's budget, but in the previous year's budget they had used a discount rate which was not consistent with the current accounting practices. So they used historical accounting standards. That discount rate was higher than every state government in this country and it was higher than the federal government. The rate used was 7.3 per cent in terms of a discount rate. The long-term bond rate was around six per cent. The federal government is at six per cent. Every other state government is around that number, between 5.7 to six per cent, yet we are at 7.3 per cent.

What does that do? That significantly depresses the unfunded super obligations of the state going forward, which then creates the position that you do not need to contribute as much from an ongoing state budget. They changed the ageing population assumptions, against national trends, and the impact of that was almost \$3 billion in the estimate period. In terms of the forward estimate, their estimation of unfunded super obligations was \$12 billion; using the old accounting standards it was \$17 billion. So there is a huge requirement, which depresses it. It is a good example of the need for transparency. If you talk to the financial press generally, that is one of the issues that is glazed over. It is not a mainstream event.

The point is that it has significant impacts and, if a state budget can be manipulated with those sorts of numbers by playing with those little levers, you are in a position, without the transparency and accountability, the result is that short-term political purposes are being driven, as opposed to the long-term prudence of state management.

The unforecast tax windfalls from 1995 to 2007 have been \$7.56 billion. That starkly sits very nicely against the cost of a new generator. The cost of a new generator, we have been told, is \$8 billion. We have had an unforecast tax windfall of \$7.56 billion. Again, that is an opportunity cost that the public will not be privy to, but it shows you the sort of waste and mismanagement that can follow if those funds are not judiciously applied. That is a very important point. It really encourages a political focus rather than a strategic focus.

The cost, in terms of the expenditure blow-outs that have come in the same period, is \$11.7 billion, so that is money spent in excess of that budgeted—\$11.7 billion additional spend and \$7.5 billion that have come in. So not only have they lost the potential for a \$7.5 billion capital injection—so long-term improvement of state finances—but it has been frittered away across a range of overspending, and we have actually gone backwards even further by another \$4 billion. So that is a significant point.

The inclusions we talk about within this are there to see, but we really think that there is a need for increased accountability and we would welcome the thoughts of the committee in terms of how you can increase accountability and transparency in relation to state budget, and we think that there are very significant financial consequences in relation to doing that. We also think that there should be increased scrutiny of strategy and the real risk, and we have spoken about those.

I will quickly read this. This is a speech that I have recently made on federalism, and I think that looking at a state budget without the context of the current federalism debate is not doing it justice.

CHAIR—Mr Baird, how long is that, because we are running out of time and we do want to ask you some questions. Could you table that, perhaps?

Mr Baird—Yes, I will table it. But I will give you a quick synopsis. In approximate percentage terms, the Commonwealth currently receives 80 per cent of revenue and a council 56 per cent of expenditure, yet the state government receives 16 per cent of revenue and a council 40 per cent of expenditure. Our recommendation in that context would be that there should be an alignment with responsibility, so that a government which is responsible for a level of services should have an alignment of revenue that matches those services.

CHAIR—Do you want state income tax?

Mr Baird—I am not going to say that, *Hansard* or not.

Senator FORSHAW—You just want more money!

Mr Baird—That essence of accountability is important and Robert Carling, who is coming in, puts that very succinctly, so his evidence is probably better. I will leave it there, Mr Chairman.

CHAIR—Thanks very much for that. Thank you also for your submission which was very detailed, thoughtful and well presented, and we thank Mr Pearce for that also. It amazes me that in New South Wales you have, as I understand your submission and I think Mr Carling's submission, legislation that talks about accountability and how to run the budgets in an open and transparent way. Is the legislation not worth the paper it is written on, or is it ignored and can't anyone force a government to comply with its own legislation? Are you conscious of that situation?

Mr Baird—Yes. When Michael Egan introduced these, the debt elimination act principle was to reduce general government net debt to a sustainable level and the important point of that was to be able to absorb economic shocks when they appeared. That was the original intent of the legislation and there are a whole range of levels with that—that is, if you are the one that administers the legislation and you are the one holding yourself to account, it is almost like getting a reference from your mother.

CHAIR—This may be a lawyer's question, but is there no-one else who can demand that the government follow its own law?

Mr Baird—That is a legal question that is beyond me because we have raised in parliament whether or not the parliament can hold the government to account on it, but it is ignored and swept away.

CHAIR—I would be interested in the Attorney-General's response from a legal point of view and the Auditor-General's as well. That is something that we might look into further. As I understand your submission, the electricity situation—some would say fiasco—has got to the stage where people have suddenly worked out that, to get the sort of generating capacity you need, you would lose your AAA rating if you had to borrow. Some would say, 'Well, what's the opposition been doing? What has the Auditor-General been doing while this situation has crept up?' over five or six years, I assume. Why is it that this came as a shock to people a year or so ago when it was first raised?

Mr Baird—If you read an annual report of the electricity generators, they do not talk about supply-demand imbalance. It is a snapshot of the 12-month performance. They will talk about long-term events often in the foreword and, in a public company context, it would be in the CEO or the chairman's report. He will have a detailed expose on the forward strategy and, at the same time, from a public market context, you are open to public market scrutiny and public market analysis. Future forecasts and models of public companies are in various computers around the city where every part of the strategy and capital program is analysed to the last dollar. In a government context, you do not have that.

CHAIR—So the accounts that you are given do not mean anything, or do not mean much?

Mr Baird—There is not the same rigour as there is in a public context, and I think the committee should be open to increased public scrutiny of long-term strategies. I am not avoiding the opposition responsibility in that, because there is a responsibility.

CHAIR—I assume you ask, but I guess you can only act on what answers you get.

Mr Baird—Yes.

Senator FORSHAW—You weren't there anyway!

CHAIR—We would like to explore this subject more with you. With the public trading enterprises, is there a dividend strategy? Do they just have a strategy of giving the shareholders—which is the government, I assume—a percentage of their profit or are they told by the government what the dividend will be?

Mr Baird—That is the million dollar question. I have been told by board members of some of these companies, as an example, that over the last three or four years they have been told, 'Do not do any strategic investments,' and that is specifically about the carbon scrubbing that we are talking about. In the US they have introduced carbon scrubbing across a lot of their generators, and emissions last year, for the first time, went backwards across the US because of this technology. That has been under way for over a decade. There has been informal advice to the various companies that, 'You're not to do that. We're just doing tactical capital expenditure.'

The only assumption you can make in relation to dividends is the same sort of discussion and, if you look at when the dividends are peaking, they are peaking at the electoral cycle—so 2003, 2007.

CHAIR—We were told in Queensland that the Queensland government tells the GBE, ‘You will pay us this year X amount of dollars as a dividend.’ Whether they have made any money or not, they still pay the dividend. Does that happen in New South Wales?

Mr Baird—That is the only conclusion that you can draw. Obviously there are numbers that are put into forward estimates and that is one of the targets that they do hit.

CHAIR—Does the Auditor-General have a comment about the superannuation situation?

Mr Baird—He did note it in his report; it was a qualification in relation to forward estimates. But that was it.

CHAIR—Was anyone embarrassed? What was the explanation of why New South Wales was so out of kilter with every other government?

Mr Baird—They relied on a report delivered by Mercer, who went through and created some of the assumptions that they went forward on. But, interestingly, I asked for the report and we got the report. The actual use of the discount rate was just a number that was given to them. So they were given a discount rate in their report.

CHAIR—Very interesting.

Senator FORSHAW—Thank you, Mr Baird. It would be good to have more time to pursue some issues with you. I appreciate that some of the issues you have raised might require a longer discussion. You have referred, as the submission does, to the electricity issue. What is the position of the opposition on the government’s proposal for ‘privatising’—to use the colloquial term—electricity? It is a more detailed proposal than that, but what is your position?

Mr Baird—We have a clear position that we are supportive of greater private sector involvement but it is not at any cost and it is not at any time. If you look at the current market conditions, which I have gone through, they are potentially the worst they have been in 20 years. If you look at the huge uncertainty around emissions trading, how can we be sure that people are bidding with any sort of degree of comfort to us; that that unknown variable is not hugely impacting on the price of the assets?

Senator FORSHAW—But you are still faced with the position, aren’t you, if you accept that there is a need to do something now about future electricity demand and generation capacity, of how you can have the luxury of saying, ‘Well, the market may not be right at the moment and may not be right for some time yet’? A decision has to be made. If you are going to criticise the government, rightly or wrongly, for failure to invest or take decisions to build new infrastructure, it seems to me it would be disingenuous to at the same time say, ‘Oh, well, we’re not quite sure whether or not we should be going down this path at this point in time.’ Sounds a bit like Mr Nelson.

Mr Baird—No.

Senator FORSHAW—Can you be categorical? Do you support the proposal of the government or do you have an alternative proposal which will produce the investment to build new generators?

Mr Baird—Let's be categorical on the last point. I have just detailed the expense overrun and the forecast tax windfalls, or the real tax windfalls that have come into this state, that mean you would not have to borrow for any generators acquired. That is the first point. In relation to our position, it is very systemic and real. The Fitch Ratings agency, when the timetable was announced, said, 'We are not actually convinced that an IPO is the best model to pursue for this privatisation. We think there is more competitive tension in a trade sale.'

It is because of those sorts of issues, together with the emissions-trading scheme, together with the market conditions, that we have asked the Auditor-General to put a report to parliament to give us an independent view on the merits of the overall transaction in the context of the current market and the unknown variables, and whether this transaction at this point in time is in the best interests of the state. I think that is a very prudent position.

Senator FORSHAW—You do not accept the Owen report?

Mr Baird—We have said that we support private sector involvement, but the interesting thing about the Owen report is that he makes very guised comments on energy efficiency. We have been very slow in relation to energy efficiency and the sceptic or the cynic would say we have not aggressively pursued energy efficiency in the last three or four years, very clearly, because we want higher energy consumption to bring a higher price in relation to sale. So the premise of the 2013 and 2014 argument is done without any material energy efficiency impacts in this state. There are questions in relation to the report, but we have said that we are supportive of private sector involvement.

Senator FORSHAW—What about the desalination plant? What is the position of the opposition on that, because it is a similar issue in broad terms of trying to future proof or provide security for future water supply. The government has made a decision and started to construct the desalination plant. Do you have a view about that, given your criticism of—

Mr Baird—Yes, an appalling decision; whether it be the energy efficiency, whether it be the cost relative to actual water recycling. We went to the last election on a water recycling platform that is far more energy efficient and cost efficient. It was given under the guise that the desal plant was supposed to come in when water levels drop below 30 per cent. They are currently sitting at 67 per cent.

Senator FORSHAW—It is raining today.

Mr Baird—Yes, so it is getting more.

Senator FORSHAW—It may not be in a couple of years.

Mr Baird—The impact to families is not insignificant. We are talking about \$150 more per year that families are going to have to pay for the luxury of a desal plant when it is not required.

Senator FORSHAW—Sorry, but we are running out of time. I could name dozens of countries in the—

CHAIR—It is not for you to debate; it is to ask questions.

Senator FORSHAW—You refer to international experience. You talk about credit ratings and so on. I can name dozens of countries where desalination plants are being constructed and plans for the future. Just go to Spain: a whole host of them. The point I am getting at is that why—

CHAIR—I do not think it is a question.

Senator FORSHAW—The question is: why do you take the view that a desalination plant is not an appropriate way to deal with potential future water shortages in Sydney on the driest continent on earth?

CHAIR—I think you have answered that, but answer it again.

Mr Baird—The same international examples. There are many cities around the world that are using recycled water, and a recycled option is far more energy efficient and far more cost efficient.

Senator FORSHAW—You refer to the AAA credit rating. We all like to maintain AAA credit ratings. What is your position or your view in terms of a reduction to a AA credit rating? What significance does that really have in terms of the state's ability to borrow or to maintain prudent economic management? Is it that critical in the view of economists or in the view of experts like you?

Mr Baird—It is an interesting debate. If you ask the market, in the context of AAA or AA, you will get a very different view. If you ask the people of the state that have been subject to a state government that has gone from AAA and below, using the Victorian experience, it is one that is very different. So I think the public have taken a view, rightly, that there is strength in a AAA rating. That is a number that the public understands, and they understand that is the top of the credit quality chain. Certainly there is enough flexibility within the AAA rating—

Senator FORSHAW—I do not disagree. This is an inquiry about financial management as distinct from public political popularity or otherwise.

Mr Baird—Yes.

Senator FORSHAW—Thank you.

Senator BUSHBY—Thank you, Mr Baird, for coming along today and thank you to your shadow Treasurer. This is a very well researched and argued and backed up submission and I would like a lot more time to ask questions about it than we have. I will focus on two points.

It has been mentioned throughout this submission about the waste and mismanagement that has resulted; you have well argued the fact that they have had windfalls and that they have wasted it. I would like to delve a little bit further into how they have wasted it. Where has the money gone in an open sense? There is a bit here on where the expenditure blow-outs have been in some categories, but has it been on more fat cat bureaucrats? Where has it ended up?

Mr Baird—It is a ragtag bunch. If you go through the budget appropriations—and I have not got the figures here in terms of some of the projects—there are hydrotherapy pools in marginal seats. I am not discounting that those sorts of things are important, but in the context of budget discipline there is a late splurge, through appropriations, where most of this windfall disappears.

Coming back to the wages point, I understand that there is a submission that talks about the wages growth in the public sector being 14 per cent higher than it has been in the private sector in the same period. That is a good example. I can talk about Sydney Ferries. Sydney Ferries is a case study in the worst management practices you could ever see. Over the last five years the revenue in Sydney Ferries has grown by 14 per cent; expenses have grown by 46 per cent.

Senator BUSHBY—Using that as an example, have those expenses grown because they have been investing money sensibly as part of a strategy in capital investment for the future, or is it just blown-out recurrent expenses?

Mr Baird—Yes, it is recurrent. It is primarily recurrent. There have been some wharf enhancements, they have upgraded some of the vessels but, just as the Owen report revealed a crisis in the electricity industry, the Hawker report, which was done into Sydney Ferries, highlights some of this mismanagement, and they are about to embark on a significant vessel replacement program that has been long overdue. The 46 per cent expense growth versus 14 per cent revenue growth, where does that come from? That comes from the state government subsidy. Again, the blow-out or lack of control in expenses has to be met from somewhere and it comes from the state budget.

Senator BUSHBY—Has the state government, to your knowledge, in the last 10 years or since it has been in government, ever taken measures to try and make major savings, like efficiency dividends or major cost-cutting initiatives? What measures has it actually introduced?

Mr Baird—There is a one per cent productivity measure at the moment, but that is ignored.

Senator BUSHBY—It is ignored. That is good to know as well. I would love to explore that a bit further but we do not have the time. On the public trading enterprises, I was going to ask similar questions to the chair, but I am also interested in a specific question. Are there any examples where the state government has sold off any assets which had been purchased by any of the PTEs potentially at an inflated price? I know in another state this certainly has occurred.

Mr Baird—None that I can think of.

CHAIR—Thank you for your brevity, Senator Bushby.

Senator POLLEY—Thank you for your submission. I thought it was fairly obvious that within the submission there was no reference at all to the Commonwealth-state funding

arrangements. In fact, it says here in the opening comments, 'The submission does not directly address the levels of Commonwealth funding to the State.' I think I know why that is not in here, but I was wondering if you could put on record why it was that there was no reference to those arrangements.

Mr Baird—The understanding was that this is: be accountable for what you are accountable for, and that is the main premise of that.

Senator POLLEY—The larger states—particularly New South Wales—have always argued that they do not get their fair share of revenue from the Commonwealth government and that they are subsidising the smaller states. We had 12 years of conservative government. I thought you might have had some comments about how well they supported the New South Wales government.

Mr Baird—The arguments around that formula are well articulated.

CHAIR—It is a Commonwealth Grants Commission formula, not a government formula.

Mr Baird—But that formula is in the public domain and is rightly being scrutinised. I am not going to pretend it is not. I think it should be looked at. But I do go back to my point on federalism generally. By not having revenue matching expenses, if you have 16 per cent of the total revenue and 40 per cent of the expenses, you are never going to be in a position where you can match it. The ongoing management outcome is that you stick your cap out because you can never match it. So what you spend does not matter because you are going to have to get a balance anyway. I think the cultural issue is the important one, and that is one of management discipline. You must be accountable for what you are spending and, if you have this mismatch, you are always able to point the finger at someone else and blame someone else, and the blame game is well spoken about.

Senator POLLEY—What is your position as far as payroll tax and stamp duty are concerned? What plans does the opposition have going forward to reduce the taxation burden on residents?

Mr Baird—We did see a reduction in payroll tax in the last state budget. We went from six per cent down to 5.75 per cent, and the closest state is Victoria at 4.95 per cent. So we are still a long way from parity in relation to payroll tax. Again, I think that is something you need to look at federally. There needs to be harmonisation. A company operating across Australia will see huge differences in relation to payroll tax rates and thresholds. It is the most inefficient system we have spoken about.

I know that we have started to work towards harmonisation certainly around the back end of collection of those taxes, but harmonisation of rates makes a lot of sense and certainly more efficiency in relation to that. The same applies to stamp duty, which is a very similar proposition.

Senator POLLEY—I am mindful of the time, but you did put on the public record when you were responding to an earlier question the issue of wastage under the state budget and the use of moneys going into marginal seats. I think it would be fair to say that the former Howard government were the masters of marginal seat campaigning.

CHAIR—That is not a question for Mr Baird. Do not even try to answer that, Mr Baird.

Senator BUSHBY—There is no answer!

Senator POLLEY—That's right! Thank you very much.

CHAIR—We could have a debate about that amongst the committee later on.

Senator BOYCE—Following on from Senator Polley's question in regard to Commonwealth funds to the states, we have had reports in recent days from a number of states that they will be unable to take up the Rudd Labor government's education revolution because there will be a \$3 on-cost for every \$1 of federal government largesse. What is the situation in New South Wales, Mr Baird?

Mr Baird—On some points I like Michael Costa and, on this particular one, I think he is right. It is kind of a ludicrous policy that you can make grandiose announcements, yet when you get down to the detail the cost is three times what you said it would be and that a level of government that was not involved in the announcement has to pick up the cost. I think Michael Costa is right to attack that position, and it is certainly a stance that we would support. I think that there are real questions for the Rudd government in relation to the delivery of that policy. When you look at reports in the papers about secret deals to placate political nuisances, to the tune of, 'Just give him \$270 million to shut him up,' I think there has to be questions asked about the new federalism and what that looks like under this current regime.

CHAIR—Do you know if that is right? Did New South Wales get an extra \$270 million? Queensland is very interested in this.

Mr Baird—Of course they are. Whether that has transpired or been effected is not yet public, and is something I am not privy to, but that was the reported figure.

CHAIR—Has the Treasurer been asked?

Senator FORSHAW—It would take a lot more than \$270 million to shut Michael Costa up!

CHAIR—I want to make sure that Hansard got that, Senator Forshaw. Senator Forshaw said that it would take more than \$270 million.

Senator FORSHAW—I'll send it to him!

Mr Baird—In New South Wales we do not sit that often. Last year we had 48 sitting days, so we have not sat since that revelation has come out.

Senator BOYCE—That is obviously part of the issue too in terms of accountability in New South Wales.

Mr Baird—Correct.

Senator BOYCE—I have one other point regarding the Commonwealth-state fiscal relationship. The Prime Minister has put the states on notice that, if they cannot fix their hospital systems, the Commonwealth government will have to look at taking them over or some such. Where would you see New South Wales sitting in the system? Is the current government here likely to be able to repair the system sufficiently within the time frame?

Mr Baird—No. We talk about that in the submission. The government has started to identify this fiscal gap that is emerging, where revenue is growing at three per cent and expenses are growing at seven or eight per cent in health. With the ageing population, I think the current forecasts are that the health budget in New South Wales will take over the entire existing budget by 2030.

Senator BOYCE—Is that using real ageing figures?

Mr Baird—Who knows! But it is at least that bad. In that context, there is a real problem. I think in the broader federalism debate, providing money to health systems that are not performing at requisite levels is kind of a nonsense. I think that is where we have to bring the accountability back. Whatever method you use to benchmark the health system in this state compared to other states, the intuitive sense is that it is well behind and we certainly would like to see some empirical data brought in to improve the performance and put on the map the need to look at the health system within that context.

Senator BOYCE—Yet your submission seems to suggest that you can have every benchmark you like for accountability, but this does not necessarily mean you are going to get good transparency, openness or accountability.

Mr Baird—Correct.

CHAIR—Going back to the hospital thing—if I might interrupt for one second, Senator Boyce—does the New South Wales opposition have a view on the cutting back of the private health insurance availability which will, to all reports, throw a huge increase onto the already overstretched public health system? Do you have a view on that in New South Wales, or does the government have a view?

Mr Baird—We cannot fund the public health requirements as they are, so to take away private incentives is just a nonsense. I only have two people on my staff, and they both have come out of private health insurance as a consequence of that policy decision. That is appalling!

CHAIR—They now go onto the entire public system.

Senator BOYCE—You talk in your report in a number of places, but particularly towards the end of the report on pages 14 and 15, about some golden rabbits that keep being pulled out of hats when the government has issues. But I was particularly concerned about the situation regarding superannuation. If I could clarify, from what you said before, the state public servants' superannuation will be underfunded and will continue to be underfunded given the discount rate that the state government is currently using.

Mr Baird—The stated goal is by 2030 to have it fully funded. The point of this is that you can manipulate assumptions and change the outcomes easily so my argument would be that, under the current assumptions, we are not going to hit that 2030 target. Indeed, we will be a long way short of hitting that target. So, yes, I think that, particularly discount rates of 7.3 per cent, should be put in the light when you look at the current market conditions as well. I would be arguing there should be an increased contribution from this state government into unfunded super, definitely.

Senator BOYCE—Apart from that, you are saying here that the government actually withheld money from super in one of their little golden hats—\$7 billion—at a time when it could have been earning 15 to 20 per cent.

Mr Baird—They started to build a future fund, and said, ‘We want to meet our unfunded obligations.’ They set up a separate fund under loose investment guidelines. So the argument would be that there could have been much greater returns with that money.

Senator BOYCE—Is there any sense of what these joint activities have already cost the super funds of New South Wales public servants?

Mr Baird—The simple point is that state public servants unknowingly are participating in short-term budget outcomes. That is an important point. It throws open to question every action by any government using those sorts of tactics.

Senator BOYCE—Would they be aware of the situation?

Mr Baird—No, the public servants would not be aware.

CHAIR—Mr Baird, thanks very much for that. We have taken you long over your timetable. Please tell the ambassador it is our fault.

Mr Baird—Yes, I will.

CHAIR—You did mention a statement. Could you leave that statement with the secretariat and we will incorporate that by arrangement.

Mr Baird—Yes; done. Thank you very much.

CHAIR—Thank you for your submission.

[10.02 am]

DEVERELL, Mr Ric, Head of Regional and Industry Analysis, Reserve Bank of Australia

RICHARDS, Dr Anthony, Head of Economic Analysis, Reserve Bank of Australia

CHAIR—We now welcome representatives from the Reserve Bank; Dr Richards, head of economic analysis and Mr Ric Deverell, head of regional and industry analysis. Thank you very much for joining us. We are keen to hear from the Reserve Bank. Thank you also for your submission. We well appreciate your situation as an independent authority and we will not involve you in any political arguments or opinions or those sorts of things. We do have your submission but did you want to elaborate or make some additional comments? I assume both of you have appeared before parliamentary committee hearings before. You would appreciate that this is a parliamentary committee and witnesses are protected by parliamentary privilege and it is unlawful for anyone to threaten or disadvantage a witness on account of the evidence given to the committee. I am sure you are aware of that. Also, if there are any answers you would prefer to give in camera, that request can be made to the committee.

Dr Richards—We do have a short statement which I will give and then we can provide it for the record. The Reserve Bank is pleased to have been invited to participate in this inquiry into state government financial management. The terms of reference of the committee are wide ranging and extend well beyond the areas in which the Reserve Bank has expertise. We will therefore limit our remarks to economic activity and inflation of the various states. The key points we would like to make are as follows: first, the Australian economy is now in its 17th year of expansion. The expansion has been broadly based and has allowed unemployment to fall to multidecade lows in all states. Second, over recent years spending growth has been faster in the resource-rich states of Western Australia and Queensland. This can be partly explained by the higher long-run population growth of these states but mostly it reflects the stimulus from the run-up in commodity prices over this period, particularly the effect on investment and the associated relocation of resources.

Third: however, we should remember that there will always be some divergence in the performance of different regions within a country and we should not overstate the degree of divergence in economic performance currently. Indeed, the divergence in year-ended growth in state final demand across the states—that is, the series in graph 2 in our submission—was below its historical average in the most recent figures.

Fourth: while higher prices for mineral commodities have a clear positive impact on the resource-rich states, as they provide an incentive to resource companies to step up output and exploration activity, they also bring benefits to the remainder of the national economy. People in Sydney, Melbourne or Adelaide hold shares in resource companies, either directly or through their superannuation funds. Firms providing manufactured goods or professional services to the resource companies may be located in these cities rather than in the resource-rich areas. As our governor has noted in recent weeks, miners buy Holdens.

Higher commodity prices also boost tax and royalty revenues to federal and state governments. Increases in revenues such as corporate and personal income taxes that accrue to the federal government benefit people across the nation and, to the extent that increases in

commodity prices and in the terms of trade result in an appreciation of the exchange rate which may hurt import-competing firms, they also are reflected in lower import prices, which benefit people all across the country.

Five: so far in 2008, aggregate growth in Australia looks to have slowed. This is more apparent in the latest data than in the data that were available at the time that we did our submission in April. We could provide updated versions of all of our charts to the committee, if desired. To date the slowdown appears to be relatively broadly based across the states. It is noticeable that consumer spending and house price growth in the resource-rich states has slowed considerably.

Six: looking forward, the recent significant increases in iron ore and coal contract prices will continue to stimulate economic activity. However, it may be the case that the stimulus will feed through into the economy more slowly than in previous episodes of large increases in commodity prices. In particular, the mining companies and infrastructure providers have already significantly increased their investment activities in response to earlier price increases, and they may have limited scope in the near term to undertake new projects made feasible by the recent price increases.

So the recent increases, if sustained, may act more to extend the longevity of the current resources boom rather than result in any major boost to activity in the short run; and it must be noted that the stimulus from higher resource prices is only one of the factors influencing the economy at present, with the global slowdown and the tightening in domestic financial conditions working in the opposite direction.

Finally, I should note that since 1993 there has been little variation in inflation rates across capital cities. While inflation has been highest in the resource-rich states over the past year, the gap with the other capital cities is modest, with inflation about four per cent in all mainland state capital cities. That is all I wish to say in our opening statement, but Mr Deverell and I are now available to answer your questions as best we can.

CHAIR—Thank you very much for that and that is a good grounding on the issues that the Reserve Bank might be able to help us with.

Senator BOYCE—I have been involved in this inquiry in Brisbane and Sydney and in both cases we have had evidence to the inquiry that state governments are somewhat prone to put whatever label they want to, on material in their budgets, for political purposes; that they move things around to suit themselves.

I notice here that you talk about a number of different indicators of overall economic activity at state level—the ABS, the gross state product. What would be desirable measures to be in place to measure state activity? Are you comfortable with what currently exists? I am talking about page 1 of your report. The limitations of GSP estimates, for instance, you mentioned.

Dr Richards—The gross state product data are only available on an annual basis and only with a lag. The construction of those data is a pretty complicated issue. So I am not sure that that is necessarily a high priority; that we need, for example, timely quarterly measures of gross state

product. Instead, what we have is a whole range of indicators on demand in the various states that we get from the ABS. We also get measures from a number of the business surveys.

Senator BOYCE—You have got the state final demand data that comes out of the states themselves. Is that correct?

Dr Richards—No, the state final demand data comes at the time of the national accounts. It is from the ABS, but it is a measure of spending in the state economies and not of production. The main difference between production and spending is that it does not cover interstate trades—that is, trade both between each other and the states and the rest of the world. That can be big because we have very large flows of goods and services across state borders and internationally.

Senator BOYCE—Are there sufficiently well-defined measures currently available?

Dr Richards—In terms of assessing the economic activity in the states, I think we have a good range of data, clearly not for looking at state product on a quarter-by-quarter basis but in looking at activity in the states, broadly defined. I think the combination of data from the Australian Bureau of Statistics and the data available from lots of other sources, including the business surveys, gives us a pretty good handle on how state economies are evolving.

Senator BOYCE—Has the Reserve Bank had any involvement with state governments as to how they go about the use of various measures within their budgeting material?

Dr Richards—No, we have not.

Senator BOYCE—I must admit, looking at some of your earlier material and some of the earlier evidence we had, I thought if a company said, ‘Look, I don’t think I’ll use you for this year, thank you. I’ll just use something else,’ there would be a huge number of authorities and regulatory bodies that would take a fairly dim view of this. Who might there be to encourage state governments to put good measurement around their budgeting processes in the future?

Mr Deverell—In terms of the economic data, which is our area of expertise, my understanding is that the state governments all report the standard Australian Bureau of Statistics measures, so I do not think that we would have any concern there. In terms of broader measures of budgetary impact in general, that is not our area of expertise, so I really do not have an informed answer for the committee, unfortunately.

Senator BOYCE—We have also taken evidence over the last hearings looking at the growing level of state debt, some of it in what are called PTEs in New South Wales but some of it within governments themselves. Have you analysed the effect of state debt on inflation in each of the states?

Dr Richards—A variant of this question gets asked of the governor twice a year when he gives testimony before the parliamentary subcommittee there. The best way to answer it is that what matters in thinking about inflation is the overall level of spending in the economy, and it is not just the level of government spending in the economy, it is also the spending by private agents in the economy. If we have an inflation problem in Australia it is because of the aggregate

level of spending in the economy. It is hard to point to any single group of agents or institutions that is responsible for the inflation problem. It is an aggregate problem.

The governor has commented that the swings in spending at the state and federal level have been pretty modest in recent years, so there really is not a sense in which one can point to years in which there has been a significant stimulus from governments of either state or federal levels that has had a material impact on the way that we think about the monetary policy decision.

Senator BOYCE—There would have been a tradition perhaps at one stage that, if the private economy stopped spending, the public economy spent, to try and keep a balance. The level of debt that we now have within the state government suggests that that nexus has been broken. What would be the view of the Reserve Bank on that issue? Do we need that balance?

Dr Richards—I am not quite sure I understand the question.

Senator BOYCE—You were talking about how inflation is fed by overall spending within the economy. The depression is probably the great classic example where we used vast amounts of public spending to prop up a non-existent private sector. That is varied, but we are clearly now in a situation where state governments are not heeding what is happening in the private sector in terms of their development.

I am thinking particularly of the resource-rich states where there are huge amounts of spending in the private economy and huge amounts of borrowing in the public economy. Should there be a balance between the two? Is it important that they not both be accelerating or decelerating at the same time?

Dr Richards—The point I would make in response to that would be that what matters is the quality of spending done by whoever is doing it. Let's talk about investment spending, for example, by the public or the private sector. There should be no presumption that the public sector should always stand aside and let all the private investment occur and then only step up to the plate if there is room based on macro-economic—

Senator BOYCE—That is the question I am asking, yes.

Dr Richards—I do not think that is appropriate.

Senator BOYCE—Relevant to inflationary pressures or—

Dr Richards—In thinking about government spending in general, federal or state, you could probably think of three considerations. The first is solvency concerns. Does the level of spending or the surplus or the deficit of the government in question raise solvency questions? That clearly has not been a consideration for any government in Australia for a very long time. The second consideration would be the cyclical nature of spending. Is it contributing a lot to inflationary pressure? And that is your question.

Senator BOYCE—Exactly.

Dr Richards—But the third consideration would be the quality of the spending, and you have to balance cyclical issues with quality issues. If there are high-quality investment projects to be done that will increase the capacity of the productive capacity of the economy, it is not clear that you should hold all of those up simply because of concerns over the cyclical. As the governor has said, there might be lots of state government infrastructure projects that, in an ideal world, might have been best done five years ago.

Senator BOYCE—Or 10.

Dr Richards—Or federal government investment, for example, that should have been done five or 10 years ago. But in thinking about the state of the economy now, we have to balance concerns over the cyclical aspect of government activity with the quality of the measures done by various levels of government.

CHAIR—Dr Richards, are you saying that infrastructure that should have been done 10 years ago and which is now being done at a time when there is overfull employment almost and wages are going up and the state governments are now coming in and competing with the resource sector and everyone else for those bodies on the ground to drive the graders and thereby pushing up wages enormously, that does not have an impact on inflation, or are you saying, if it is good infrastructure that they are getting people to drive the graders for, then too bad about the rising wages, it is good for the country, so let's go ahead and do it? Am I overstating what you are telling Senator Boyce?

Dr Richards—I will repeat two points. It is the overall level of spending that matters in the economy, and I do not think there should be a presumption, as I said earlier, that every last little bit of private sector investment should go ahead and one should only do the public sector investment if there is room. We should be thinking about the quality of all investment spending in the economy, regardless of whether it is public or private.

CHAIR—I am not an economist, but it seems to be commonsense to me that state governments now belatedly embarking upon huge infrastructure projects are disproportionately pushing up wages which, in a simple commonsense way, I suggest is one of the big drivers of inflation in our country.

Dr Richards—I think it is important to look at the magnitudes involved. When we look at the data on the state government fiscal positions, it is not clear that there has been a particularly large expansion in fiscal stimulus coming from the state level.

Mr Deverell—When you are thinking about the impact of the government sector on the economy, the shorthand that economists tend to use is that you look at the change in budget balance from year to year. It is a very rough estimate and there are criticisms of that, but in terms of trying to get a feel for what impact they are having on spending in the economy, that is the best metric we have. If you look at the general government state sector, there is very little change from 2006-07 to 2008-09. Our general conclusion is that, in aggregate terms, there is very little impact on the broader economy in terms of stimulus or withdrawal of spending. That is the first point I would make.

Senator BOYCE—Is that just government or GOCs as well?

Mr Deverell—If you add in the public trading enterprises, there is a slightly positive stimulus in 2007-08 and then again in 2008-09, but it is of the order of magnitude of a quarter to a half of a percentage point of GDP, which is pretty small bickies in terms of the broader scheme, and it is not inconsistent with the kinds of moves that you have every year. It is not something that we felt compelled to factor in in a significant way when setting monetary policy. The impact is at the margin rather than one of the main drivers in terms of economic activity.

But more generally in terms of Senator Macdonald's point about state government infrastructure spending crowding out the private sector, the way we look at that is twofold. Firstly, I think it is unambiguous that, if the big mining companies had anticipated that commodity prices would have risen so much, they would have invested a lot more 10 years ago. When you are talking about the resources sector, in particular, the state governments probably would have invested more in terms of the kind of infrastructure to get this stuff to market, but that is just the world we live in.

If you think just about resources, a good example would be the coal ports in New South Wales and Queensland. If you think about the logical consequences of where you can go with this, at the moment state governments are significantly increasing spending on, particularly, port infrastructure in some of these places, and that is a very good thing in terms of getting some of these products to market. It is very complicated in terms of saying, 'Yes, there is a lot of private sector spending; therefore, state governments should not spend,' whereas a lot of the time there are synergies between the two kinds of spending. By increasing infrastructure, you actually therefore increase the capacity of the private sector to get their product to market.

In the short term, certainly there can be some additional cost pressures, but over the longer term they are alleviated. So it is kind of a timing issue. It is not our area of expertise to make a judgement as to the appropriate balance—that is up to governments—but it is more complicated than just saying that increased capital spending by state governments is crowding out private activity. There should not be a presumption that one is superior to the other. Indeed, at the moment you could probably argue that they are both very useful. It is how they are sequenced and how they are put together, and that is not our area of comparative advantage.

Senator BOYCE—As you mentioned, you got long-term gain out of that and short term, one would have anticipated, an inflationary effect from all that pouring of money into the system. Is that not the case?

Dr Richards—From all of the spending in the economy: the consumer spending; the business investment spending; the public investment spending. It is the total level of spending that matters.

Senator BOYCE—You spoke about the quality of investment. Could you elaborate a little bit more on what you mean by 'quality'.

Dr Richards—Exactly what Mr Deverell just said. It is investment that raises the productive capacity of the economy in the long run. That is clearly productive and easily measured, and no doubt there is social investment that is just as productive but which we would have less expertise in commenting on.

Senator BOYCE—I am thinking in terms of perhaps the desalination plants that are being built here. Where do they fit on this scale?

Dr Richards—That is something we could not comment on.

Senator BOYCE—Thank you.

Senator POLLEY—Thank you for your submission. I wanted to seek some further clarity and get your comments on record in relation to the shift from the nineties when state governments were looking to reduce their debt to now having to invest in infrastructure. Would you care to put any further comments on the record in relation to the change and what that means to the states and to inflation?

Dr Richards—The only comment I would make is that we are very fortunate in Australia that we have a low level of government debt. There are many central banks in the world that would envy our position of low levels of both Commonwealth and state debt. If state governments are in a position to borrow without it affecting their credit rating, that is presumably a very good thing. The question of the appropriate level of state government borrowing is not within our area of expertise.

Senator POLLEY—In relation to my home state of Tasmania, it is pretty rare in comparison to other states at the moment anyway, in that Tasmania has been able to reduce its overall debt quite significantly and at the same time invest in infrastructure. Would you care to comment on whether or not there are lessons there for other governments?

Dr Richards—I just do not know the detail, I am sorry.

Senator POLLEY—We are seeing the mining boom and how that is pushing the economy and the reference to it being a two-speed economy at the moment. Would you care to comment on the skills shortage and the impact that that has had through the lack of investment by the federal government in training over the last 12 months and the impact that has had on the states?

CHAIR—The federal and state governments, I think she means.

Senator POLLEY—I actually meant the federal government.

CHAIR—All right.

Dr Richards—We could not comment on that sort of issue. We have had a long expansion, and it is probably not entirely surprising that we are, as you say, running short on labour, both skilled and unskilled. It is actually a reflection of the success of public policy in recent decades that we do have a very low unemployment rate and we should be very glad we do, but, to the extent that there are labour shortages, that is a problem that many other economies would probably be delighted to have.

Senator FORSHAW—To go back to some earlier comments you made, you listed three principles. You mentioned cyclical spending or cyclical investment. Can you clarify what you

mean by ‘cyclical spending’ or ‘cyclical investment’? This is for state governments. You were referring to the different areas of spending.

Dr Richards—They were just three considerations that one might have in thinking about government activities and the impact on government solvency. The cyclical impact is whether or not it is contributing to demand at a time when demand in the economy elsewhere is weak, so it is the sort of countercyclical spending that Senator Boyce referred to in the time of the Great Depression.

Senator FORSHAW—Thank you. I had in my mind, as well, the situation where government—state governments particularly—are confronted with ageing infrastructure or certain other pressures that come along, one might say cyclically, and effectively it is spending that has to be undertaken if the system is going to continue. This is what state governments—and I am talking about New South Wales—are saying: that a lot of the infrastructure, particularly rail and hospitals, is 60 to 70 years old and has to be renewed. Would you agree that a fair amount of state government spending is non-discretionary? By that I mean specific purpose payments moneys that come from the federal government and other federal government funds that are tied, together with the running of the normal services of the state government: teachers, hospitals, salaries et cetera. In that context, what can be done to improve state government financial management, when the taxation system is the way it is and, if I am correct, a large proportion of state government funding is non-discretionary? Our next witness, Mr Carling, looks at the need to reform the taxation system and also in part looks at SPPs.

Dr Richards—Our expertise is in broader macro-economic issues and it is probably something we cannot usefully comment on. I suspect you have many other witnesses that can speak more directly to that question.

Senator FORSHAW—Am I incorrect in saying that the current system leaves state governments in a situation where they do not have a lot of surplus funds for either discretionary spending or for ploughing into infrastructure development? Is that a fair representation? I am not trying to make a political point here, by the way. I am actually trying to get to the nub of an issue that is always part of the debate, and that is that the states are hamstrung for funds. For instance, the expansion of Sydney, the population growth, is such that the demand for increased services is strong. In the current taxation arrangements, the ability for any state government to get the extra funding is limited, and obviously they go to a whole range of other taxation forms—gambling, whatever—to make up that shortfall.

Dr Richards—The issue is: are there a number of types of expenditure which are non-discretionary? I am sure that is true for the state government and the Commonwealth government, and local governments too, but the question of the implications of that for intergovernmental fiscal issues is something that we just cannot comment on, I am sorry.

Senator FORSHAW—Okay. I am not sure if you heard me: I asked Mr Baird, the previous witness, about AAA ratings. You made a comment earlier about ratings. How significant is a downgrading of a credit rating from AAA to AA, for instance, for a state government in the overall assessment of economic performance, either of a state or of the nation?

Dr Richards—That is an issue we think about more, probably, at the Commonwealth level. I could not usefully comment on state government ratings except to say, as I said earlier, that the fiscal position that we have at the Commonwealth and state levels is one that many other central banks would be delighted to have. I suppose the only comment on ratings is that there is a tendency to look at debt levels alone, and to also think about net worth, and debt that funds productive infrastructure is by no means a bad thing.

Senator FORSHAW—So it could, at least in certain circumstances, be not good financial management to focus so much on maintaining the credit rating that you avoid making decisions for productive, worthwhile investment, in infrastructure particularly, into the future?

Dr Richards—I will address that from a different angle. I hope that, when the rating agencies think of credit ratings of state and federal governments, they think not just of the level of debt but of the level of assets, and I am sure they do, yes.

CHAIR—You said you had not thought about it at a state level but you had thought about it at a federal level. What is the difference between an AAA and an AA rating, federally? Or am I misinterpreting what you said?

Dr Richards—You are probably reading more into what I said than I intended.

CHAIR—But you did say you had thought about it from a federal point of view and that that was more your area, rather than the state, which you had not really thought about, so what was your thinking in relation to the federal government? I think that would give us an indication of your thinking across the board on this very technical subject, which is obviously one that Senator Forshaw has thought about a bit.

Dr Richards—The context of my statement was that we sometimes meet with the credit rating agencies when they are doing a review of the Australian government rating—the sovereign rating, the sovereign ceiling, for Australia. We think of issues that are relevant to the way that the credit rating agencies think about the national economy, but we just have not been involved in the discussions that they would have at a state level in thinking about state government ratings.

CHAIR—How would it impact on the work or the conclusions you draw in your terms of reference if the federal government rating were, hypothetically, reduced from AAA to AA? The air conditioner going off was not a pause for effect there!

Dr Richards—That is something that is probably not particularly relevant to today's terms of reference so it is something I have not thought about in preparation for this meeting, but the bottom line is we have got an inflation target and that is the mandate that the bank has been given and that is something that we can achieve regardless of what credit rating Australia holds.

Senator FORSHAW—I was looking at this issue for this inquiry of state government expenditure. A lot of the debate is obviously about spending on infrastructure, on provision of services et cetera, whereas at the Commonwealth level it would seem to me that the relevance comes in in exchange rates or in the level of overseas borrowings and monetary fluctuations and so on. To me, you are looking at two different sectors of economic activity.

Senator BUSHBY—While we are discussing credit rating risks, in terms of actual consequences of a downgrading of credit rating, that has impacts on the rates at which a government can borrow and so forth, doesn't it? Is that a fair comment?

Dr Richards—Usually, yes.

Senator BUSHBY—So if a government was downgraded, be it a state government or the federal government, then it would find the cost of borrowing money had increased, which would then have other consequences in terms of spending decisions that they could make because they would be spending more on interest.

Dr Richards—There is not necessarily a linkage between the cost of borrowing and the credit rating, but in practice investors pay significant attention to the credit rating.

Senator BUSHBY—We have heard as we have travelled around the country in just about every state that the state governments have, over the last seven or eight years, certainly experienced significant windfall gains in terms of the actual revenue that they have raised in any year compared to what they initially budgeted. This morning we have heard that since 1995 New South Wales has received an extra \$7.56 billion in what is termed 'windfall gains'. However, at the same time it has increased its spending by some \$11 billion over and above what it had originally budgeted to spend through that period.

Would it be the case that—using New South Wales as an example but an application for all states—if New South Wales had, upon finding that it had \$7.56 billion more than it had budgeted for in its initial papers, invested that in infrastructure on the way through, that that would have had a lower inflationary impact than allowing that and more to be spent in recurrent spending, particularly if it were clever; if they did spend it in infrastructure that improved productivity? You are talking about how you spend it.

Dr Richards—There have been large windfall gains at the state and federal level in recent years because economic conditions have proved to be stronger over a long period of time than we could have expected. I am not sure I would want to get into thinking about a counterfactual situation.

Senator BUSHBY—I am using that as an example, but basically asking this question: if governments, upon finding that they had more revenue than they budgeted for, made a conscious decision to invest that as they went in improving productivity by spending on infrastructure—hypothetically rather than using a specific example—rather than allowing that to be spent on more public servants et cetera, recurrent spending, would those two different choices have any effect on inflationary pressures?

Mr Deverell—It is a very complex issue, but again I would draw you back to earlier comments that, from the Reserve Bank's point of view, at least in the short term, what matters in terms of the impact of fiscal policy on aggregate demand in the economy is the change in the budget balance.

Senator BUSHBY—Exactly.

Mr Deverell—So when you talk about windfall revenue gains, another way of saying that is that the forecasters just got it wrong.

Senator BUSHBY—Yes, that is right.

Mr Deverell—That is an extraordinarily difficult thing to say so I am not criticising the forecasters, and it just turned out that there was more revenue than had been anticipated. But the actual spending path over the past decade or so has been relatively stable. There have not been big jumps from year to year. So in terms of the short-term cyclical impact of the state government spending, it has not been a major consideration for us setting monetary policy. To put it another way: we do not think it has been a significant factor pushing inflation one way or the other; it has been broadly neutral over that period year to year.

There is a debate about what is the appropriate social level of infrastructure in a whole different bunch of areas. We could have a long discussion about that, but it is really not within the Reserve Bank's remit to talk about that kind of issue.

Senator BUSHBY—No, I understand, and I am not going to ask you those questions. You came back to the actual circumstances of the difference between budget to budget. What I want to know is whether a government choosing to spend more money than it was originally predicted to have on recurrent spending, rather than investing it in productive infrastructure, whether it is at the margin or otherwise, would have an effect on inflation or inflationary pressures?

Dr Richards—I should say that this is well beyond our area of core expertise. I imagine it is somewhat difficult to reach assessments as to the productivity of a lot of spending by governments.

Senator BUSHBY—But presuming that a government did spend money on productive infrastructure.

Mr Deverell—In the short term the way we think about it is a dollar is a dollar is a dollar. They all feed into demand and it is spread across the economy. In the short term, as a general summation, we do not get into the game of trying to look at, 'This particular bit of spending has a bigger impact on demand than this bit of spending' because it is much more complicated than that. So it has not been a consideration for us.

Over the broader term some people will mount an argument that if you had a higher level of infrastructure then there would not be supply constraints, which is what I think you are getting at. But that is a social policy decision that is well beyond our remit, and what I would say to you is that it is interesting that a lot of the private sector also did not put the infrastructure in place that would have been very useful at the moment in terms of increasing productive capacity, particularly in the mining sector.

Senator BUSHBY—Once again you are coming back to the specifics of what people have actually done. I am trying to find out in a more pure economic sense what the effect of decisions would be if governments made them rather than looking at specifically what people have done. I did use the example of the evidence we have heard over the last few months about what state governments have done, but then I am trying to work out at a more theoretical level what they

could have done which might have had a different impact so that we can look forward and work out where we go with recommendations.

The reason why I was asking this question was because, when we have asked questions of you and other independent bodies, you ask, 'Surely if the federal government spending money is said to have an inflationary impact, if the states are spending more money that must as well,' and they say, 'No, no, it is much more complicated than that because you've got to look at how they spend the money,' et cetera. So I am trying to get to the bottom of, if they did spend the money differently, what the impact would be.

Now you are telling me that a dollar is a dollar. When we asked whether a dollar is a dollar initially and, 'State governments are spending a dollar like the federal government is, then won't that have an inflationary impact?' you say, 'No, a dollar is not a dollar.' So I am trying to work out what is the actual case. If a state government decided to spend money that it did not know it was going to have on recurrent spending, what impact would that have on inflationary pressures compared to a state government that decides to spend money it didn't know it had on productive infrastructure?

Dr Richards—Earlier on I said one could assess fiscal policy on a number of measures. One of them is, in a sense, the quality of the spending.

Senator BUSHBY—Which comes back to whether a dollar is a dollar or not.

Dr Richards—The general point is that it is important for governments of all levels, be they state or federal, to do high-quality spending, much of which we hope will add to the productive capacity of the economy. I agree with the observation that windfalls, regardless of who gets them, should be spent as wisely as possible and in high-quality ways, whether that be for current social purposes or for future productive use. We could not object to the principle that it is important for governments of all levels to put in place capital stock which will boost the productive capacity of the economy in the future.

Senator FORSHAW—It seems to me that the premise of Senator Bushby's question is wrong. If you are talking about excess recurrent expenditure based upon tax windfalls or whatever as against decisions to use that excess revenue to put it into future investment, they are two different types of spending. By their very nature they do not all occur in the same period of time; therefore, they cannot necessarily have the same inflationary impact. If you are talking about increasing recurrent expenditure over, say, a 12-month, two- or three-year period, as against ploughing \$7 billion into investment which might be run out over 10, 20, 30 years, it is totally different. It seems to me to be obvious.

Senator BUSHBY—I think you are clouding the issue.

Senator FORSHAW—I am not.

Senator BUSHBY—I am not making a premise; I am asking a question.

Senator FORSHAW—Your question is premised on alternative uses of excess income.

CHAIR—I am sure that the witnesses are able to handle themselves.

Senator BUSHBY—I am asking what effect that might have. I think we will move on from that. You did mention—and you touched on this in answering some of my questions earlier—in your response to Senator Boyce that the difference in spending by state governments between the 2006-07 and 2008-08 year is not that great. Can you say the same thing about the federal government spending over the same period?

Mr Deverell—In broad terms, yes.

Senator BUSHBY—You also were discussing the relative merits of private and public expenditure and the effect on the economy. Isn't it a general economic principle that if a government spends money to the exclusion of the private sector—in the sense that it spends money so as a result the private sector does not—it is accepted that there is a dead loss to society as a result; as a pure economic theory?

Mr Deverell—I would not think so, no.

Senator BUSHBY—I recall when I was studying, I think, macro-economics in first year-economics, we had all these—

Senator FORSHAW—Did you pass?

Senator BUSHBY—I actually got a high distinction, to be honest! It was some 23 years ago. I can recall graphs showing a little shaded area which was a dead loss to society when government pushed out private expenditure by spending. You do not recall anything along those lines?

Dr Richards—I think we would need to see more specifics.

Senator BUSHBY—It is a bit rusty. It was something you said that made me think about that and recall it. I cannot lead you to the water too well. Thank you.

CHAIR—Do you know, or could you have a guess at, the size of government expenditure in Australia versus private expenditure?

Dr Richards—We do not have estimates of the—

CHAIR—Is it about equal?

Dr Richards—No, absolutely not. The share of government spending in the economy is much lower than the share of private spending in the economy.

CHAIR—I will not hold you to this, but could you give me a guess: 20 per cent?

Mr Deverell—Can we take that one on notice?

Senator FORSHAW—You're asking the Reserve Bank to have a guess! I know what you are trying to say, Chair.

CHAIR—The only reason I am not happy about them taking it on notice is that it then ruins my next question because I do not know.

Dr Richards—It is more than 20 per cent.

CHAIR—Well, between 20 and 50 I take it; so let's pick 35. You are not saying that but I am guessing that.

Senator BOYCE—You are postulating.

CHAIR—Yes, I am postulating. I was interested in your comments, as I understood them—and, again, this is in very simple layman's language—that government spending 'is the aggregate of all spending, not of sectors', I think your words were. We have had evidence from a number of different submitters, suggesting that government spending is not productive. As I started to say, a witness tomorrow will be telling us that in New South Wales public sector wages have increased 14 per cent beyond private sector wages in the last few years, suggesting that it is not productive expenditure. Even on my figures—35 per cent of the economy—if that expenditure by all governments is not as productive and the wages are going up higher in the public sector than the private sector, wouldn't that then have an impact on inflation by reckless spending—my term—or by inappropriate spending by state governments?

Dr Richards—Over long periods of time public and private wages have grown at broadly similar rates. There may be times when they grow at slightly different rates, but they grow at fairly similar rates over long periods of time.

Senator BOYCE—What is a 'long period of time'—10 years, or longer?

Dr Richards—Yes, 10 years, I think.

CHAIR—We can take this up with Professor Ergas tomorrow, whom you probably know. I quote from his submission:

The poor performance of State and Territory governments in part reflects failure to contain public sector wage costs. In the period from September 1997 to March 2008, increases in the Labour Price Index for the public sector in many States and Territories substantially exceeded those for the private sector. Over the same period, the Labour Price Index for the Commonwealth public sector closely tracked that of the private sector as a whole.

That is the Commonwealth Public Service: It continues:

Most noteworthy is New South Wales where State Government wage growth exceeded that in the private sector by over 14 percentage points.

That is in the 10 years.

Senator FORSHAW—It is a shame we had to pay teachers and nurses and others more money, isn't it?

Mr Deverell—I think that is right—

CHAIR—No. It is productivity. I mean, pay them—

Senator FORSHAW—He is just saying that the wages bill has gone up more than in the private sector. That is all he is saying.

Mr Deverell—I do not have the exact data in front of me but in terms of what would be appropriate, it does not surprise me that different sectors in the economy have different wage rates. It really depends on whether those wage increases are underpinned by productivity. For example, it is not surprising that over the past couple of years mining and construction wages have grown more rapidly than other sectors in the economy, but I do not have enough information and I do not know the detail enough to have a strong view as to whether New South Wales' wage increases are appropriate and the Commonwealth's are not.

CHAIR—You are suggesting, from what you say, that the 14 per cent increase in New South Wales is productivity based over the private sector.

Mr Deverell—I do not know whether that is the case or not.

CHAIR—You are reluctant to be hypothetical, I appreciate that, but again a commonsense look at this from a noneconomist would suggest that, if public sector wages are increasing by 14 per cent over the private sector, they are 14 per cent more productive, which I do not think anyone would accept as the case. No? Yes? No comment?

Mr Deverell—No.

CHAIR—I am challenging, from an amateur's point of view, the assumptions you are making. This is getting back to my principal theme: if state governments are spending 35 per cent of the national spend and are pushing up wages for no productivity gain, that must have an impact on the nation's inflation rate. You are telling me it doesn't?

Mr Deverell—Firstly, in terms of our hypothetical, I think 35 might be a reasonable approximation for the whole government sector; certainly not for the state government sector. It would be much smaller than that.

CHAIR—Whatever it is—20 per cent—it is still a big sector, isn't it? If they are pushing up wages unproductively, it must have an impact. I mean, who am I to argue with PhDs in economics, as someone who did grade 12 economics? But commonsense tells me that, if you have a sector of national economy that is spending 20 per cent and paying far more than a productive wage rate, that must have an impact on inflation. This is germane to our inquiry. I am not giving the evidence. I am trying to understand what you are telling us in that regard.

Dr Richards—We do not have state-level wages data here in front of us, so it is hard to comment specifically on any particular number that someone else have given you. The general principle that public sector wages are important for inflation is correct.

CHAIR—As I understand it—and I might be misinterpreting you—when some of us are saying, ‘If the state governments had planned for infrastructure 10 years ago they wouldn’t be in this desperate catch-up situation now, which is pushing up wages and must be pushing up inflation,’ you are then making the comment, ‘If the private sector had realised there was going to be a boom, they would also have invested in infrastructure.’ But again, commonsense and general knowledge tells me that the infrastructure—you are talking particularly about the resource industry—is going on. The big boom in spending in the resource sector is current expenditure. It is digging the metal out of the ground and putting it through a furnace.

Senator BUSHBY—And paying people \$100,000 to serve in the cafeteria.

CHAIR—Yes, as we have heard. You answer that as you interpreted my question, but I might clarify it after.

Dr Richards—I think the evidence is that there are a lot more people employed in the infrastructure investment phase of most mining projects than in the actual production phase. These things do not need all that much labour on an ongoing basis. It is large spending on capital costs, a lot of people, a lot of equipment and then relatively smaller labour needs on an ongoing basis. So we have investment in Australia at high levels and it is mostly because of investment in infrastructure-type things that are largely associated with mining.

CHAIR—Do you have data on that? Could you get that for us?

Dr Richards—Absolutely.

CHAIR—The expenditure in the resource sector, capital versus recurrent?

Dr Richards—For some selected projects we could show you some evidence of that. We could also provide some data showing the pick-up in investment spending that is related to the mining sector, in recent years.

CHAIR—I live in Townsville and Townsville Airport is crowded every morning with people going out to work in the mines, both west and south into the Bowen goldfields. I am reasonably confident they are not working on capital projects; they are working on digging the stuff out of the ground and getting it overseas.

Senator BOYCE—Would those figures be available as a split between public and private investment as well?

CHAIR—I was talking about the resource sector.

Senator BOYCE—But the coal ports and the roads and a lot of other of the investment that is belatedly being done is related to the resource sector.

CHAIR—Senator Boyce was picking up on what I am saying. My anecdotal evidence from flying around the country is that state government spending is on infrastructure that should have been done 10 years ago. I think Senator Boyce's point was: do you have the data on this as opposed to resource sector spending which, my impression is, is more on recurrent rather than infrastructure? Do you have that sort of data that you might be able to get to the committee?

Dr Richards—We will provide some data on this.

Senator POLLEY—Could I just ask for that further information to include not only the investment by state governments in infrastructure but also by the Commonwealth government over the last decade or so, because that is an interesting point to be made as well.

Dr Richards—If it is budgetary information, it is probably better that it comes from Treasury. What we can do is slice and dice the national accounts data on investment in a way that might be helpful to you, but I do not think it will get at quite the level of detail that you would like. We will be able to establish the principle that the pick-up in investment in the economy is, to a large extent, caused by activities related to the mining sector and less so in the more traditional industries.

Mr Deverell—We will have a go at this, but it is difficult to separate out what is construction expenditure on mining and what is recurrent expenditure on mining—that is, how much of this new activity is building the plant and how much is ongoing mining activity?

CHAIR—There are not a lot of plants being—

Senator BUSHBY—Really it is just infrastructure: railways and ports.

CHAIR—The railways and ports are the infrastructure, which is state government. We have run out of time, but perhaps if we could impose upon you to refute or comment upon this proposition: that state governments are now paying more in wages than they should because they are 10 years delayed in essential infrastructure. I guess perhaps that is it, which is sort of encapsulating what I hope I have been trying to learn from you. I know you say the Reserve Bank governor each six months is asked the question, 'Is it state government?'—what some allege is poor financial management impacting on inflation—and the answer is, I think, 'Depends.'

What I am putting to you as a rank amateur is that unpredictable spending by state government is pushing up wages, which is having an impact on the things we have been talking about. Could we impose upon you to give us a couple of pages response to that, if that is within your purview. I am not wanting you to get into the politics or the political debate. I am simply trying to understand. This was one of the underlying principles of the whole inquiry, which as you rightly say perhaps we should be asking Treasury about, but you are a lot further removed from political masters than Treasury might be.

Dr Richards—We can certainly consider that, but the question of assessing what spending is productive, what spending is non-productive, whether spending on physical assets is productive whereas spending on teachers is unproductive, is something that is not our area of expertise.

CHAIR—No, but if wages, according to Professor Ergas—I am sure he has given his reference but I cannot find it; I am sure he would not be telling us fibs—have gone up 12 per cent higher than private sector wages in New South Wales across the board, there seems to be something wrong. That must then, I would commonsense-think, have some impact on inflation.

Dr Richards—We will look at some data on total labour costs in the public and private sectors, but I note that the wages price index is just one measure of wages growth in the economy and it is not as broad as some other measures. The broader measures which are more likely to capture bonuses et cetera are more likely to be paid in the private sector. It may be that the wage price index is not a perfect measure of the entire payments for labour in the public and private sectors.

CHAIR—Thank you very much, Dr Richards and Mr Deverell. You have been very generous with your time and very patient with answers to people who do not obviously share your expertise. We appreciate your assistance.

[11.11 am]

CARLING, Mr Robert, Private capacity

CHAIR—Dr Carling, thank you very much for coming. Your reputation precedes you to our committee. I am conscious that you should feel free to get up at 12 o'clock and move out, even if we are midquestion. We will just have to discipline ourselves a bit more. Thanks for your time and for your submission, which we very much appreciate from someone with your background and reputation. If you would you like to make an opening statement, we will then ask you some questions, if that is in order.

Mr Carling—Thank you. I should point out that I do not have a doctorate, so I will have to settle for 'Mr' Carling. My submission discusses Commonwealth-state fiscal relations and state taxation in broad terms and is therefore overarching in relation to the committee's more specific terms of reference as listed in items a. to j. I should also say by way of general introduction that when I refer to the states I am referring to the states and territories in aggregate rather than any particular state. If I need to refer to a particular state in the course of my answers, I will do so. I will make that clear.

I wish to emphasise the following points: firstly, that how one approaches the topic of this inquiry should depend on what kind of federation one wants for Australia. My view is that Australia would be best served by a robust form of federalism, by which I mean that the states—as well as local government, for that matter—would be assigned a clear set of responsibilities appropriate to the subnational levels of government and have sufficient fiscal autonomy to carry out those responsibilities.

Secondly, Australian federalism has drifted away from these conditions over a period of decades and now clearly does not come even close to what I have described as a robust form of federalism. In particular, the states are too dependent on Commonwealth grants, their own revenue bases are too narrow and too dependent on undesirable types of taxation, and the Commonwealth encroaches too much on areas of service delivery that are more appropriately the domain of the states and territories.

Thirdly, the grant of all GST revenue to the states under the intergovernmental agreement of 1999 has not solved the problem of excessive state dependence on Commonwealth grants. In fact, it has made the states even more dependent. Even though I would willingly agree that that intergovernmental agreement was beneficial as an exercise in national tax reform, I do not think it was beneficial as an exercise in federalism reform.

Fourthly, the current debate about reforming federalism is missing some of these fundamental issues. While there is now a strong and legitimate focus on improving the design of specific purpose payments and state taxation has been included in the federal government's major review of the tax system, the states' dependence on Commonwealth grants, in both GST revenue and specific purpose payments, is not being discussed, even though it is fundamental to how well the federation functions.

Fifthly, the issue is not whether the states are adequately funded to carry out their current responsibilities. They may or may not be. Rather, the point is that if they were more self-reliant

in their funding they would be more accountable to their citizens and more efficient and effective in service delivery.

Finally, the reform of federalism, it follows from what I have said, should include measures to replace existing inefficient state taxes as well as some Commonwealth grants, and this would require the states to apply their more efficient taxes more broadly. It would also more than likely require the Commonwealth to make room for the states to enter one or more of the broad tax bases that are currently monopolised by the Commonwealth. The most obvious one, given the constitutional constraints and economic considerations, would be personal income tax. I will leave my opening comments there and invite your questions.

CHAIR—Thank you very much for that, Mr Carling.

Senator POLLEY—Welcome, and thank you very much for your submission. I found it most interesting. When you are talking about reforming the special purpose payments, could you give us some evidence of the sort of reform that you believe we should be undertaking.

Mr Carling—The states have been agitating about the design of specific purpose payments for many years. Some action is being taken on that through COAG at the moment, where they are reducing the number of different SPPs, consolidating them and making them less based on input controls and more based on performance and outcomes. That is all very well and to the good, but it does not alter the fact that the Commonwealth is, through these specific purpose payments, very heavily involved—and increasingly so over the years—in areas of state service delivery and policy in most fields, particularly health and education, and that this is part of the problem of overlap and duplication that we hear about.

Whilst there is a justification for some specific purpose payments, and they exist in all federations around the world, I think they have been taken too far in Australia and there is scope to reduce them very substantially and strip them back to areas where there is a genuine national interest. I think that the total of the specific purpose payments is now about \$23 billion or something of that order of magnitude, excluding the ones that are ‘through’. There is this distinction between specific purpose payments ‘to’ the states and those ‘through’ the states, which are mainly the payments to local government and to independent schools. I exclude those because they are essentially using the states as a postbox, but the ones to the states, where the states are their final resting place, are about \$23 billion and I think that figure could be cut back very substantially and replaced by the states being admitted back into a broad tax base, with the Commonwealth stepping back and making room for them.

Senator POLLEY—In your submission you make reference to reforming state taxation. Can you elaborate on what you mean as far as state taxation is concerned.

Mr Carling—There are the residual reforms left over from the GST agreement of 1999, and the states have agreements with the previous federal government and, as far as I know, are adhering to those agreements, to abolish certain taxes according to a timetable which I think will be completed in about 2011 or 2012. Those are still to be done, but they are being attended to, and it includes things like stamp duty on mortgages and leases and hiring arrangements and so on. But there are still some stamp duties: there is a stamp duty on insurance; there is a stamp duty on motor vehicle registration; and there is the biggest one by far, the stamp duty on real

estate transfers. I think that these suffer many of the deficiencies of the stamp duties that have already been abolished or are scheduled to be abolished, and should be the subject of a second round of state tax reform, either curtailing them substantially, or abolishing them altogether if that could be managed.

In addition to that, there are payroll tax and land tax. Payroll tax is the largest state tax and land tax is one of the largest ones. They are very narrowly applied at the moment and they are the best taxes that the states have available to them. As part of the second round of reform, they should also be applied more broadly and at lower rates. That is what I mean by 'further state tax reform'.

Senator POLLEY—I was most interested, being a Tasmanian senator, in your comments relating to centralisation, and in fact in your submission you refer to the Howard government's takeover of the Mersey hospital leading into the last federal election. I think that was another example of marginal seat politics. Over the last 30 years, that hospital in particular has gone backwards and forwards between state government and private enterprise. It is just a very difficult issue. Do you want to make any further comments in relation to that type of intervention in interstate matters by federal government?

Mr Carling—I think that was another example of undesirable Commonwealth intervention in state affairs. Another one, I would say, is the establishment of the Australian technical colleges, without any state involvement, and being set up alongside the state systems. This is the kind of thing that blurs accountability and is an undesirable direction for federalism to take.

Senator POLLEY—There have been attacks on the states in terms of wasted expenditure and resources, and that is a prime example of very poor utilisation of limited resources going into skills training. I might add that it was long overdue, but, rather than try to duplicate what was an already successful TAFE program, the federal government would have been better off putting those resources into what was already established. In relation to local government, we have the Local Government Association coming before us tomorrow, and obviously there have been a lot of reviews into the roles of various levels of government. Where do you see the future of local government in this country?

Mr Carling—I think that local government serves a useful purpose in the federation. They often talk about being given a share of GST revenue or revenue more generally. I am not sure that that is the right way to go, because it raises the same problem of dependency on another tier of government that I talked about in my opening comments. I think local governments have a reasonable tax base already available to them in the form of rate revenue that is suitable for their responsibilities, and it serves the purpose, without local government being admitted to a broader revenue base such as GST revenue.

Senator POLLEY—I am mindful, Chair, of the time. I am sure I have stimulated some other questions from the panel, so I will hand it over.

CHAIR—I am sure you have. You do not think local government should be given a fixed share of GST revenue. Did I hear you say that?

Mr Carling—Yes, that is right.

CHAIR—It almost happened in Queensland, actually, and local government have been ruining the day that the minor parties removed certain items from the GST which then allowed the Queensland government to renege on a commitment. But that is a debating point that I could pursue some other time. Mr Carling, in the executive summary of your second paper you talk about COAG's business deregulation objective and about harmonising tax bases and administrative practices, particularly in relation to payroll tax, to reduce compliance costs. Does 'harmonise' mean the same as 'the same' in that context?

Mr Carling—In that context, yes, it does.

CHAIR—You are advocating a standard payroll tax, if we have to have one, across all of the states and territories—more or less the same sorts of thresholds, the same sorts of rates?

Mr Carling—No, I am not advocating the same rates of payroll tax or tax-free thresholds. I am talking about the definitions of what is subject to payroll tax—

CHAIR—I see.

Mr Carling—and the administrative arrangements for collecting it. I think it would even be worth exploring the possibility of the Australian Taxation Office being the centralised collecting agency for payroll tax. I do not know if there would be any constitutional impediments to that, but it would be worth exploring. I certainly do not mean uniform rates of payroll tax or thresholds. If you went that way, there would be no point in having a payroll tax in the first place, because the whole idea of state taxation is to enable the states to be different and to do their own thing, and if you iron out all the differences then you have defeated the purpose.

CHAIR—Okay. I have read in one of these papers or somewhere else that your proposition on state income taxation is for the Taxation Office to continue to collect it as now, but if you lived in the state of Queensland, the Queensland government would say that the first 10 per cent of your tax you would pay X per cent, whereas New South Wales may say on that first 10 per cent you would pay Y per cent. Is that how it would work, in a one-liner, for what is obviously very well thought through and more detailed?

Mr Carling—Yes, that is right, as you have described it, and it would be made very clear to the individual taxpayer how much was going to the state and how much was going to the federal government.

CHAIR—Fraser did do that for a little while, didn't he?

Mr Carling—The Fraser government—I think it was called new federalism in 1976—passed legislation to allow the states to impose a surcharge on top of federal income tax rates or grant a rebate against federal tax obligations, without jeopardy to Commonwealth grants to the states at the time. But that was never taken up by any state, and the federal government did not make room for the states to step in. In other words, if any state had chosen to impose a surcharge, it would have been just on top of what the federal rates were at the time. The federal government did not pull back its rates to make room for the states, which is an important difference from what I am talking about should be done.

CHAIR—From your experience, do you think any of the state governments would be interested in that state taxation on the basis that you put—for example, that the Commonwealth government pulls back 10 per cent and then the states can use that 10 per cent, or less or more, for individual—

Mr Carling—They may not be all that vocal in advocating it, but the states themselves have advocated it at times in the past, and in the design that I have advocated they would not have much choice because they would be losing Commonwealth grant revenue at the same time and would have to make it up somehow.

CHAIR—You mentioned nuisance taxes. Can you remind me of what nuisance taxes are and give me a few examples.

Mr Carling—It is a term that I have borrowed from the Business Council, I suppose. They use it a lot. It really means fragmented taxes that raise little revenue and have—

CHAIR—A lot of red tape.

Mr Carling—a high level of compliance and administration costs for the amount of revenue that they raise. For example, there are various levies. New South Wales has a parking space levy which Victoria I think has now adopted for central Melbourne. It is that kind of thing. I went through the whole list of state taxes and added up all the revenue that all the states raised from these kinds of taxes and it was not much more than \$1 billion, which sounds a lot but it is not in overall terms.

CHAIR—How would you counter the suggestion that, as you suggest, broadening the tax base by lowering the tax-free threshold for non-residential and taxing all residential land, whether owner occupied or not, at a very low flat rate, is a regressive tax that then impacts more heavily on lower income earners than the very wealthy?

Mr Carling—Firstly, I advocated this in the context of withdrawing or at least substantially reducing the stamp duty on real estate transfers, so you have to look at the two together, and the stamp duty on real estate transfers may also be regressive. Secondly, you cannot judge an individual tax in terms of whether it is regressive or progressive; you have to look at the whole system. Certainly some taxes you can say are regressive, but when you look at the overall tax transfer system that impact can be offset by something else. You have to look at the system in its totality.

CHAIR—Thank you, Mr Carling. I will not rise to Senator Polley's encouragement to ask you about Mr Rudd's promise to take over hospitals if the states do not fix them up, or his promise to give every child a computer, providing the states pay for it, nor will I rise to it being put that the Australian training colleges had to come about because the TAFE system was so inefficient and not providing the service that people wanted. I will not rise to those. I will, instead, pass on to Senator Boyce.

Senator BOYCE—Well done, Mr Chair! I was considering whether I was going to rise to those as well but, yes, we will try and control ourselves. We took evidence in Brisbane, Mr Carling, from Commerce Queensland, who are the largest representative of private enterprise in

Queensland, that payroll tax was the No. 1 pet hate of Queensland business. I imagine that it would come in the top three in every state in Australia. You are proposing a broadening of the payroll tax base.

Mr Carling—Yes.

Senator BOYCE—What would you anticipate would be the political result of states doing that?

Mr Carling—Fairly contentious, I imagine. I think it is unfortunate that the states have chosen to compete on having the highest possible payroll-tax-free threshold and then boasting about it, and Queensland is one of the examples of that.

Senator BOYCE—It has been wound back slightly, yes, in the last budget.

Mr Carling—I think the ACT has a payroll-tax-free threshold of over \$1 million and I think the Northern Territory has a very high one at the moment also, and some of the other states have been a bit more cautious about increasing it. I acknowledge that politically it would be very difficult, but it is not my job to rule out things on political grounds. You could say the same thing about land tax.

Senator BOYCE—You could. You would.

Mr Carling—I would, but I try not to allow my recommendations to be unduly influenced by those considerations.

Senator BOYCE—However, that probably in practical terms leaves your suggestions around developing a state income tax system by the federal government vacating some of that area as one way that the states could get more money. Is that true?

Mr Carling—I do not necessarily see it as a way of the states getting more money overall. I see it as a way of the states getting more control of their own destiny.

Senator BOYCE—More power.

Mr Carling—And more financial autonomy.

Senator BOYCE—You obviously, then, have serious concerns about the way the Commonwealth Grants Commission goes about divvying up the GST?

Mr Carling—That is a separate issue that I have not really touched on here but, yes, I think that system leaves a lot to be desired. I think I said something about it in the ‘Fixing Australian federalism’ article.

Senator BOYCE—I must admit then I have some difficulty understanding how the states do not have control over the expenditure of GST revenue.

Mr Carling—They do have control over expenditure of GST revenue but they do not have control about over-raising it. I know that the intergovernmental agreement says that the states and territories have to agree to any change in the rate or base, but that has to be unanimous. So no individual state has any control over the GST; they just receive the revenue from another tier of government.

It is nothing more than another form of Commonwealth grants or the hypothecation of GST revenue to the states. Of course, they have discretion as to how it is spent, the composition of the expenditure, but they are not answerable to their electorates for how the money is raised. That is the key point.

Senator BOYCE—You have mentioned in your submission on ‘Fixing Australian federalism’: ‘There is no denying that the states are not delivering services to the satisfaction of all users.’ You go on to suggest that that is not simply about the devolution of powers, that there are other reasons there, in your view, for that happening. We have taken evidence in I think every state about financial mismanagement—unusual labelling of items within budgets by state governments—yet you are proposing that they should have more money, and more control over the sources of that money. Can you discuss that point?

Mr Carling—Once again, I am not necessarily advocating that they should have more revenue in total—

Senator BOYCE—Sorry, more control is what I said.

Mr Carling—just greater autonomy. Let me take a step back. I said that there is a lot of dissatisfaction with state service delivery. One only has to read the newspapers to know that. But the answer to that is not taking away their powers; it is designing the system so that they use their powers more responsibly, more efficiently and in a more accountable way. I believe that if they were more accountable to their own electorates for how the revenue is raised and how much is raised, there would be more pressure on them to be efficient and effective in the way they spend the money.

I think that, in criticising the states for deficiencies in service delivery, there is often an implication, if not a stated assumption, that the Commonwealth would do things better, and I do not think there is any justification for that assumption. The Commonwealth has no track record in running the police forces, apart from the Australian Federal Police which really has quite a different function from state police forces. It has no track record in running schools, apart from these Australian technical colleges, which are a new thing. It has no track record in running public hospitals and so on. There is no basis for thinking that the federal government would be more efficient and effective in running these things. In fact, it is easy to point the finger at the failures in Commonwealth administration in areas where it does have responsibility.

Senator BOYCE—Nevertheless, moving on from service delivery, as I said, we have had evidence in each state around what appear to be quite blatant and deliberate attempts to obfuscate revenue expenditure and budget allocations. What pressures are there on states for that type of behaviour? I do not understand why they could not be open and accountable about their budget processes, irrespective of where the funds are coming from.

Mr Carling—I do not know what specific examples you are referring to there. As far as I am aware, transparency and accountability in the state budgets is no worse or better than transparency and accountability in the federal budget.

Senator BOYCE—And the relevance of that is? I do not think that is at all the case, but we are talking about state budgets and financial management. For instance, there was evidence given this morning that the New South Wales government has potentially breached its own Fiscal Responsibility Act in the way it has gone about allocating items within its budgets and within its time lines and guidelines. I am concerned here that you say that holding state governments to account through the democratic process would apparently improve their financial management, when we have numerous examples given to the committee in pretty much every state that we visited where this is not happening within their current budget process.

Mr Carling—I accept what you say—that people have said it is not happening within the current budget process—but I would maintain my position that, if that is the case, pressure should be applied to them to do better.

Senator BOYCE—By whom?

Mr Carling—By public opinion, by media, by the opposition in parliament, by all the democratic institutions that exist.

Senator BOYCE—And you would see giving more power to these bodies as likely to improve their behaviour in these areas?

Mr Carling—I think if they were more answerable to their electorates for raising the money in the first place, that would increase the pressure on them to perform.

Senator BOYCE—You have spoken in ‘Fixing Australian federalism’ about some of the current government’s plans, which I think have been spoken about, to look at some of the areas of federal-state relations. How do you think the process is currently going?

Mr Carling—I think that a lot of the things that are being done under the heading of ‘Cooperative federalism’ are worthwhile and desirable in themselves. I would not agree with all of them necessarily, but I think a lot of them are worthwhile and desirable and the process seems to have a lot of momentum, perhaps more so than at times in the past. But I do not think that what is being done under the heading of ‘Cooperative federalism’ is by any means comprehensive in respect of desirable reforms of federalism. As I have said, I do not think it is addressing this issue of state dependence on the federal government for revenue or what is otherwise called vertical fiscal imbalance. There does not seem to be any interest in addressing that issue. Maybe it will come up in the review of the taxation system—I do not know—but at the moment it is not being addressed.

Senator BOYCE—How would you characterise then, for instance, the situation that has arisen in regard to the education revolution, where the states have somewhat belatedly worked out that they are going to need to spend up to \$3 for every \$1 that the federal government will be putting into computers in schools and yet were not consulted about these on-costs when this great education revolution program was announced?

Mr Carling—I cannot really comment on that. All I know is what I have read in the newspapers.

Senator BOYCE—But the states were not consulted. Is that an example of the sorts of things that you were talking about as being a problem?

Mr Carling—From what I read in the newspapers, it seems to have been an oversight.

Senator BOYCE—The sort of oversight that other governments were being criticised for as well?

Mr Carling—I cannot comment on that.

Senator BOYCE—Thank you.

Senator BUSHBY—A couple of other senators have asked questions on this, but you mentioned in your opening address that in your opinion the GST has made the states more dependent on the federal government. You noted that there were advantages that had come of out it, but in terms of federalism it has not been positive. Would you say that it has actually harmed federalism? Is it a negative or has it just not advanced the cause of federalism, or working federalism? To assist you, it did remove half of the annual grants fight involving how much money was coming. That still obviously leaves how it is carved up. There used to be the fight about how much they were going to get before they started. Now at least they know what the size of the package is.

Mr Carling—It has made the flow of general purpose grant revenue to the states more predictable and perhaps more secure—more difficult for the Commonwealth to change unilaterally. But it has not advanced the cause of federalism in the following sense: in part it has replaced a set of taxes which the states controlled themselves individually, even though they were not desirable taxes by any means, but it has replaced those with Commonwealth grant revenue. In that sense, it has increased the states' dependence on federal revenue and reduced their fiscal autonomy.

Senator BUSHBY—Reduced their flexibility to make local decisions that they believe are better for their state. There are some other negatives but that is the main one.

Mr Carling—You have to weigh against that the benefits of the tax changes that were made.

Senator BUSHBY—Yes.

Mr Carling—The replacement of what I have elsewhere described as a bunch of Third World taxes, such as financial institutions duty and debits tax and so on, by a more efficient broadbased tax—namely, the GST.

Senator BUSHBY—You have advocated, as we have heard this morning, a form of state income tax, and we have discussed how that might work, to some degree. Have you looked at other options? Have you examined, for example, the way that Germany—which is also a federation—divides the tax intake amongst the federal government and provincial governments?

Mr Carling—I am aware in general terms of the German model. I am not an expert on it, by any means. I think that it involves a quite centralised tax policy.

Senator BUSHBY—With, I think, some guaranteed shares to the—

Mr Carling—That is right, yes; constitutionally guaranteed shares.

Senator BUSHBY—But you have not examined that in detail. More locally there are other alternatives and, in asking this question, I will be taking the opportunity that Senator Macdonald declined to take up regarding hospitals, and I am just using this as an example more than anything else. The federal government prior to the election said that they will take over the national hospital system if it could not be sorted out within a couple of years, if I recall correctly. Ignoring the politics of this, which suggest to me that they will probably wriggle out of that regardless of the state of the national health system at the time, would you support such a measure as a way of aligning revenue and responsibility if the federal government did try and do that at some point? You have probably answered that to an extent by saying that you do not believe the federal government has experience in running hospitals, but it would solve the issue of aligning the responsibility and revenue-raising capacity to an extent, I believe. Is that something that you would see as advisable or having any benefits?

Mr Carling—Obviously there are two ways of solving vertical fiscal imbalance: one is to give the states more revenue autonomy, and the other is to take away some of their expenditure responsibility. There may be some expenditure responsibilities that the states currently have that could be shifted back to the federal government. I cannot think of any offhand, so I do not think that that is the key to resolving vertical fiscal imbalance, and I do not think that shifting responsibility for public hospitals back to the federal government would be part of it. It is not just a question of whether the federal government would be more or less efficient at running them, but is it the kind of expenditure program that should be performed by a central government or is it the kind that should be performed by a subnational government that is more responsive to local communities?

Senator BUSHBY—Tailored to local conditions. I have a view on that.

Mr Carling—I think it falls into that category.

Senator BUSHBY—We have touched on state income tax and, even with the measures that you suggest whereby you cut back the national tax before you put on a state tax, it is going to have some politically unpalatable consequences. If it is the federal government that is forcing it, they may wear some consequence of creating a situation where states can implement their own taxes. Even if the net effect for a given taxpayer on the day that it occurs is nil, there is still a new tax, and that could be sold and used to political advantage by certain parties or certain interests. How do you think you could go about selling it to avoid that? Do you think it is politically achievable, as desirable as it may be on your argument?

Mr Carling—As I said in response to an earlier question, I am really not qualified to comment on the politics of these things. There are other people who are expert at doing that.

Senator BUSHBY—Are you trying to convince politicians to make a decision to do it and then we can work out how to actually set it up?

Mr Carling—I would suggest that at the time of the change there should certainly be no overall increase in personal income tax, and maybe even a reduction in the overall personal income tax take, and probably the states should be locked into that share for a few years and only then be given the freedom to adjust their rate up or down, and perhaps they could only do so within a limited range.

Senator BUSHBY—Of course, thereby lies the attack point obviously: once you give the states the ability to do it, then who knows where they will go?

Mr Carling—I do not think that any one state would want to be the first to increase their rates.

Senator BUSHBY—I think there is a political reality there, but if you were trying to create mischief at the early stages then certainly you could raise that issue.

Mr Carling—Yes. If we go back to 1976 in this state, a state election campaign was run on the issue. It was the spectre of double income tax that helped change the state government.

Senator BUSHBY—That is right. It would be very easy to manipulate if people had less than honourable intentions. They are most of my questions, but I do have one small question on the removal of stamp duty or reduction of stamp duty. House prices are largely the responsibility of people to pay. If you took the stamp duty off, do you think that people would factor in that they have the extra money and the prices would be pushed back up to what they could have paid anyway and they would lose the benefit?

Mr Carling—This is the economic incidence versus the legal incidence of the stamp duty. There could well be some reaction of the kind that you have described. The converse of that is that at the moment, in effect, the seller is bearing the burden of the stamp duty. I do not advocate this primarily on the grounds of the cost of housing; I advocate it on the grounds of efficiency and promoting greater turnover and mobility—turnover in the stock of housing and mobility of households.

Senator BUSHBY—Thank you.

Senator FORSHAW—I recall the 1976 election. I do not disagree with what you said but I also recall that some of the issues that were involved there were the same as 1966 or 1988: fresh leadership; problems with transport; health; education. It seems it is ever the case with state elections. I want to ask you about SPPs. Again, I have some sense of *deja vu* here because I can recall in 1996, just after the change of government at the federal level, I was a member of the Public Accounts Committee on an inquiry where the refrain by new government members was constantly about the need to get rid of or reduce the number of SPPs; that these had grown too much and there was a need for state governments to have greater control over their own expenditure. So I was very interested in the comments in your articles that you have provided. What has happened with SPPs since 1996 to date, under the previous government? I did not find

any figures in your article about whether they had dramatically increased or reduced, or whatever.

Mr Carling—If you look at the long history of SPPs, they have tended to have surges of growth and then retracted; they have ratcheted up and down and up and down, but the net effect has been that they have grown over time. The period that you have talked about has probably been one of the periods where they have advanced in aggregate; as a percentage of GDP, probably not greatly, but you must remember that over that period GDP has been growing quite rapidly. They have at least kept pace.

Senator FORSHAW—The arguments back then were very much also couched in the sort of political rhetoric of the centralist versus federalist attitudes of the relevant political parties. Is it worthwhile now trying to re-establish federalism in the way it may have been, where states had some greater degree of control over their finances and expenditure, given what has happened and given High Court decisions and things like industrial relations legislation, and also given the sense of the need for national focus on a whole range of issues, particularly those that involve state services? I am thinking particularly of the health and education sectors, where there is constant debate about inconsistencies in delivery and performance. Those two sectors make up a heck of a lot of the state government's budget.

Mr Carling—That is a very big question.

Senator FORSHAW—Sorry, yes. But you understand what I am saying?

Mr Carling—I understand what you are saying.

Senator FORSHAW—Achieving national standards or improving the national standards.

Mr Carling—Yes. It really takes us to the whole philosophy and theory of federalism and, as I said in my opening comments, how you approach this subject depends on what kind of federation you want. I think it is worthwhile trying to roll back the frontier of centralisation, as it were. I am not suggesting that you can go back, or even should try to go back, to 1901.

Senator FORSHAW—Yes, I am not suggesting that you are suggesting that.

Mr Carling—No. With uniformity, it is horses for courses. I think there are some things where uniformity is justified. People always raise the example of uniform rail gauges. That sort of thing is obvious. For other things I think it is justified for the states to be different. I do not, for example, think that there needs to be a national uniform school curriculum. I think there is nothing wrong with the states having their own school curricula. But I do think that it is worth trying to salvage the best of federalism from the situation that we currently have.

Senator FORSHAW—You were asked about local government by Senator Polley. Local government, of course, in this state has to raise revenue under a system of rate pegging, which limits the amount by which they can increase their rate revenue each year. Is that something that should continue to exist, in your view? Local government is constantly complaining about that.

Mr Carling—None of the other states have it and I do not think it should continue in New South Wales. I think that local governments should be answerable to their local communities for the rates that they want to raise, just as any other tier of government is for its taxes, but I think that there has been some circumvention of the New South Wales rate pegging regime. Each year there is quite a long list of special exemptions, special increases, for particular local government areas, so this has diluted the force of the rate pegging regime anyway.

Senator FORSHAW—But that is based upon arguments that the state government has put more pressure back onto local government for funding for libraries and things like that.

Mr Carling—State mandates, yes.

Senator FORSHAW—Yes. Thank you.

CHAIR—Councils hate it. Ratepayers love it.

Senator FORSHAW—I should declare I think, too, that my wife is a councillor, so I hear about this quite regularly.

CHAIR—Mr Carling, thank you very much for your attendance and for your submission. We have very much appreciated your input.

Mr Carling—You are welcome. I hope to have been of some assistance to the committee.

CHAIR—You certainly have been. That concludes today's public hearing. The committee will now adjourn and will reconvene in Canberra tomorrow.

Committee adjourned at 12.09 am