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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**

MONDAY, 19 MAY 2008

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

Monday, 19 May 2008

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

Participating members: Senators Abetz, Adams, Barnett, Bernardi, Birmingham, Mark Bishop, Boswell, Brandis, Bob Brown, Carol Brown, George Campbell, Colbeck, Collins, Coonan, Cormann, Crossin, Eggleston, Ellison, Fielding, Fierravanti-Wells, Fifield, Fisher, Heffernan, Hogg, Hurley, Hutchins, Johnston, Joyce, Kemp, Kirk, Lightfoot, Lundy, Sandy Macdonald, McEwen, McGauran, McLucas, Marshall, Mason, Milne, Minchin, Moore, Murray, Nash, Nettle, O'Brien, Parry, Patterson, Payne, Ronaldson, Scullion, Siewert, Stephens, Sterle, Troeth, Trood, Watson, Webber and Wortley

Senators in attendance: Senators Bushby, Chapman, Forshaw and Ian Macdonald

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.

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Committee met at 10.50 am

CHAIR (Senator Ian Macdonald)—I declare open the second public hearing of the Senate Select Committee on State Government Financial Management. The committee was established by the Senate on 14 February to inquire into the fiscal relationship between the Commonwealth and the states and territories, as well as state and territory financial management. We have received 39 submissions so far. All of them have been authorised for publication and are available on the website.

These are public proceedings although the committee may agree to a request to have evidence heard in camera. This committee is a committee of parliament and it is protected by parliamentary privilege. It is unlawful for anyone to threaten or disadvantage a witness on account of the evidence given to a committee. Any such action may be treated by the Senate as a contempt. It is also a contempt to give false or misleading evidence to a committee. If any witness objects to answering a question, the witness should state the ground on which the objection is taken. The committee will determine whether it will insist on the answer, having regard to the ground on which it is claimed. If the committee determines to insist on an answer, the witness may request that the answer be given in camera.

[10.52 am]

WELLS, Mr Kimberley Arthur, Shadow Treasurer and Member for Scoresby, Victorian Parliament

CHAIR—I want to welcome Mr Kim Wells, the shadow Treasurer of Victoria. Thank you very much for coming along, Kim, and thank you for your submission. I think you have provided the secretariat and all of the members with an updated and revised submission on the Victorian budget. I understand you have provided all the committee members with a PowerPoint slide which you want to refer to without presenting it. We all have that and that is in order if you want to take us through that. Would you like to make an opening statement before subjecting yourself to questions from the committee?

Mr Wells—Thank you, Chair. I was elected to parliament in October 1992 and was given the position of shadow Treasurer in December 2006 by the current Leader of the Opposition, Ted Baillieu. I am also the Deputy Chair of the Public Accounts and Estimates Committee, so it is an unusual role for me to be on this side of the table rather than on that side of the table. We are going through the public hearings stage at the moment. We originally submitted a document to you entitled ‘Submission to the Senate Select Committee on State Government Financial Management’. Since the budget, we have updated that document to incorporate what has taken place in the budget that was brought down on 6 May. So the revised submission obviously incorporates that, as well as an additional couple of comments in regards to the teachers EBA. The teachers EBA was agreed to in theory the day before the budget was brought down, so it was not incorporated in the budget papers. I have submitted that document to you.

My opening comment is that the budget that was brought down is a debt driven budget and it focuses on maximum taxation and minimum services. Victorians have never been taxed as much as they are now, and the problem that we are having is that the size of the budget has doubled in just eight or nine years from \$18 billion to \$36 billion. But many Victorians would argue that, taking out the increase in population and the cost increases, they have not seen a doubling in service. Although we have seen record taxation being paid into Treasury, the level of debt in the state has increased from \$3.5 billion in 2002 and will reach \$23 billion in 2012. It is a worrying sign when you have massive amounts of revenue coming in but at the same time the state wants to go further and further into debt. We are still struggling to get the state government to explain the level of debt that it is now undertaking.

In addition to that, 15 new taxes have been introduced. My understanding was that when the GST came into play a number of state taxes would be abolished. But we have not seen that in this state. Just to recap, we obviously have the increase in taxation. We have poor services. We have a health service that is underfunded. We have waiting lists approaching 40,000. We have little kids who are waiting for cardiac surgery being rejected six or seven times by the Royal Children’s Hospital before they can actually get seen. That is not the fault of the hospital. It is a situation of underfunding. We have the lowest number of beds per hundred thousand in our health system of anywhere in Australia. Our education standards have fallen. Our public transport, especially our trains, is in a very interesting situation. Although patronage has increased by 50 per cent, we have only bought 10 new carriage sets in the last eight years. Our

road system is in gridlock and violence in our community has increased from 31,000 reported violent crimes to 42,000. We are swimming in money but we are not fixing the problem. If we are going to fix the issues within the state, we believe that spending should be on those items which are going to fix the problem and increase productivity. If you increase productivity, it has less of an impact on inflation. Chairman, would you like me to step through the graphs at this point?

CHAIR—Just before you do that, you mentioned 15 new taxes. Can you tell us about those and what they are?

Mr Wells—As I mentioned, the understanding of the federal government was that the GST was to substitute a number of state taxes; a number of state taxes would be abolished. There have been 15 new taxes applied. The 15th tax is in dispute. A business rental duty which was introduced by the government seems to have been withdrawn, so we are in limbo and we are following that through. We have the following additional taxes: a gaming machine levy; payroll tax on fringe benefits; payroll tax on apprentices and trainees, which is quite extraordinary; stamp duty on mortgage backed debentures; annual indexation of fines, fees and charges so instead of there being an open and transparent process on how charges should apply in the state, it is automatic; a transit city tax; a stamp duty extension on landholding bodies; payroll tax on employment agencies; a five per cent water levy; and a long-term parking tax—this is the so-called congestion levy, which has been an absolute shambles; the idea of that was to discourage people from coming into the city, though I think it has actually made it worse—land tax on trusts; a land development levy; an inbound international airline stamp duty extension; and a waste landfill levy. As I said, the 15th is one that is still in some question with Treasury and the government, and that is the introduction of the business rental duty. I will provide this sheet to the committee for inclusion.

CHAIR—They were all new as of this budget?

Mr Wells—No, that is from 1999 when this government came in. Sorry, I should have clarified that. They are new or an extension of an existing tax.

Senator BUSHBY—Was the 15th one supposedly introduced with this budget?

Mr Wells—There is some confusion over that and we will apply to Treasury for a clear understanding.

CHAIR—Has this budget raised the confusion?

Mr Wells—This budget had it down as zero whereas before we had it being introduced by the government. Now all of a sudden they have put zero in the forward estimates. We need to seek clarification from Treasury and Finance about what they actually mean with that. It seems to be that they applied to have it introduced, but there seems to have been some pressure from the business community. Maybe they have backed down, but we need to seek further clarification on that.

CHAIR—Would you like to go through your PowerPoint presentation?

Mr Wells—Graph No. 1 shows that the GST started off at around \$5.1 billion and it is now up to \$10.3 billion, so that has doubled over the last five to six years.

Senator CHAPMAN—Is this Victoria's share?

Mr Wells—This is Victoria's share. That is an extraordinary amount of GST. That is ironic because the state Labor government were so opposed to the GST. But, now that the GST is in play, they seem to have backed away from opposing it.

Graph No. 2 is the issue of land tax. We make the point that the government is very reliant on property based taxes. The government promised at the time of the last budget, which was just the other week, that they would cut the rate of land tax by 10 per cent, from 2.5 per cent to 2.25 per cent. But the reality is that the overall take for the government will be up by \$300 million. So, even though it sounds good for spin and rhetoric purposes, the reality is that there will be an extra \$300 million of land tax take.

Graph No. 3 shows what is hurting many Victorians when it comes to housing affordability. The issue with stamp duty is that they are going to cut the threshold by 10 per cent, but on a median priced house in Melbourne, which is \$432,500, a person will be paying \$18,000 in stamp duty, which is the highest of any state in the country. So we pay the highest level of stamp duty of any state on a median priced house of \$432,000. The reality is that, even though they are going to cut—

Senator FORSHAW—I am sorry; how much is a median priced house?

Mr Wells—A median priced house in Melbourne is \$432,500.

Senator FORSHAW—I thought you said \$132,500. I thought, 'He's doing well.'

Mr Wells—No. It is \$432,000—I am sorry, Senator—and on top of that you would pay \$18,000 in stamp duty.

CHAIR—I have to say, as a Queenslander, that we like to hear these things. Please keep going and ignore that comment.

Senator FORSHAW—I will not.

Mr Wells—By cutting the threshold by 10 per cent, an extra \$900 million—almost \$1 billion—in stamp duty will be coming in, with increased property prices. Graph No. 4 is the issue of payroll tax. To the government's credit, they have cut payroll tax from five per cent to 4.95 per cent, so it is under the five per cent range—and it has not been that way for some time. But the problem is that the threshold of \$550,000 has not changed. So, as small businesses pay their employees pay increases, more and more small businesses will be caught up in the payroll tax net.

CHAIR—When was that \$550,000 last adjusted?

Mr Wells—I am sure that the \$550,000 threshold was not last adjusted in this term of government, but we will follow that up.

CHAIR—Wages have gone up—

Mr Wells—Exactly. As a result, more small businesses are paying payroll tax. A small business in this state is a business that has 20 or less. So 20 or less means that obviously more and more small businesses are paying payroll tax. The issue is that we welcome the cut of the rate, but the threshold has not been adjusted, and that is where they are getting more. In fact, despite the cut, with payroll tax they will collect an extra \$200 million from businesses in Victoria.

Senator BUSHBY—How does that threshold compare with other states?

Mr Wells—We have the lowest threshold of any state in the country, so we are at a distinct disadvantage because of people hitting \$550,000. I was at a Geelong catering company at the end of last year and they had no idea that, because they were expanding slightly, they would be caught up in it. They were not forecasting it and, unfortunately, they were hit with a payroll tax bill that they were not expecting and that is causing difficulty for that business. So, from our point of view, we want the government to adjust the threshold.

Senator FORSHAW—What did you say the rate was?

Mr Wells—It was five per cent and it has been cut to 4.95 per cent, but the threshold is still \$550,000. Graph 5 is a summary of tax increases, with the right-hand side of 2007-11 showing the tax take over the next four years of pushing \$12 billion.

Graph No. 6 is the issue of debt, which we are very concerned about. In 1992—on the far left—when I first came into government with Jeff Kennett as Premier, we were faced with a debt of \$33 billion. We were borrowing about \$3 billion a year to pay for the wages of nurses, teachers and police. We had significant difficulty with that debt but, as you can see, the debt was paid down. The debt profile paydown was out to 2002, where the total debt was \$3.5 billion. Now we are seeing that debt level increase and by 2012, as I mentioned in my opening statement, it will hit \$23 billion.

Senator CHAPMAN—This is budget paper estimates?

Mr Wells—Yes, these are all in the forward estimates; they are not our figures. The cost of servicing that debt in 2012 will be \$1.8 billion in interest repayments. The cost of our police force is \$1.77 billion today. So a simplistic summary would be that you could double the size of your police force each year rather than pay interest. As we say, the issue of debt is fine and we can legitimise it if it is being spent on issues of productivity. In addition, we believe that the Prime Minister at the moment is very focused on inflation. But, if you use your debt to improve productivity, it does not have an inflationary impact.

CHAIR—Are you in a position to explain briefly the difference between public non-financial corporation and general government debt?

Mr Wells—Public non-financial corporations are such things as your water authorities, ports and railway tracks. They are the authorities that are 100 per cent government owned and—

Senator CHAPMAN—They have not been privatised as yet?

Mr Wells—The water authorities, no. They will be responsible for the desalination plant or the pipeline coming down from the northern side. A good example is the water authorities, when it comes to building pipelines. General government debt is your department of education and your department of justice; it is that sort of debt. So there is a distinction between your authorities and your normal departmental debt.

CHAIR—Is this an annual debt amount, or is it an accumulated—

Mr Wells—As at 30 June in that particular year, that is what the debt level is.

CHAIR—Is that total government debt?

Mr Wells—Total government net debt.

CHAIR—I am just curious about this. One of our later submissions suggests that there is no debt in Victoria. It talks about net operating balance or surplus and deficit.

Mr Wells—Is that cash?

CHAIR—Yes, that would be cash—‘net operating balance’. Anyhow, we can inquire about that.

Mr Wells—Just to clarify: the figures on graph No. 6 are the debt levels as per the budget papers and the forward estimates.

CHAIR—Yes.

Senator CHAPMAN—Senator Macdonald has just said that this other submission refers to the cash position or operating surplus; therefore, how is the debt rising? If each budget, according to that, supposedly is in surplus, where is the debt coming from?

Mr Wells—That is the concern of my submission—they have a significant surplus and they have significant taxes, but at the same time they wish to increase debt. We would argue that if it were being spent on issues of productivity then you would understand that it is less inflationary. We have asked the government for a full list of where they are applying this debt so we can have a better understanding of what they are building to fix things, because we do not see that at the moment. It is an extraordinary situation where you have record levels of taxation and revenue, but at the same time there is still the desire to increase debt. Most people would argue that you would use your cash surpluses to build infrastructure, then you would use PPPs—work with the private sector—and then as a third resort you would use debt. But you would at least tag that debt for a particular infrastructure project.

Senator CHAPMAN—That was going to be my next question. At this stage, you do not know whether those extra borrowings are going into long-term infrastructure—which some would argue is a legitimate reason for borrowing, because you pay it off over the life of the particular item and over the generations that are getting the benefit from it—or whether it is going into some recurrent expenditure.

Mr Wells—We have asked the Treasurer, through the Public Accounts and Estimates Committee, to provide a list of the tagging of that debt, because I do fear that some of the debt being used is for recurrent expenditure. I hope that I am proved wrong when they bring down the list, because that is a disastrous situation. There has been a suggestion that they are replacing some worn-out infrastructure, but we would like to look at the list because I am concerned that some of it may be used for some parts of recurrent expenditure.

Senator CHAPMAN—I recall that, when we had our hearing in South Australia, the opposition representative there made the point that there appeared to be a lot of maintenance work, which would normally come out of the budget recurrent expenditure, being described as capital. I wonder if perhaps that is the same thing that has happened.

Mr Wells—Yes. That is exactly what the concern is. You are capitalising your maintenance costs over a four- or five-year forward estimates period. That is the fear, because maintenance, to me, is obviously recurrent. They are trying to make sure that they have a healthy surplus and they are using loans to repay capitalised maintenance costs moving forward. To me that is the wrong way of incorporating that. That is just blatantly wrong. The issue is also that we use a lot of PPPs in this state. EastLink is a totally private road. They are looking at building 10 or 11 new schools using PPPs. So you would think that would not be incorporating government debt if you are using a PPP system. So there is some confusion and we will be very—

Senator BUSHBY—So where is the money going? You have highlighted that they have had huge revenue windfalls over the last 10 years, and yet you have also illustrated the problems that the state is facing through lack of investment. What are they spending the money on? Where is it going?

Mr Wells—There has been roughly \$5 billion of cost overruns and blowouts, and that is disappointing.

Senator BUSHBY—Is that in recurrent budgets?

Mr Wells—No, that is in capital. For example, the cost of the channel deepening started off at less than \$100 million. It is closer to \$1 billion. The fast train started off at \$80 million and they were going to get private involvement. That was just under a billion dollars. We had the situation of the West Gate M1 contract which went from \$1 billion to \$1.363 billion. We have a list of almost \$5 billion of those sorts of cost overruns. It is of concern that poor financial management and poor contract management are costing this state. We do understand that there are cost increases over the life of a contract, but those cost blowouts are significant.

Senator BUSHBY—What about on the recurrent side? Has that blown out as well? What are the figures on the numbers of public servants at the moment? Do you have any figures showing how that has grown since 1999?

Mr Wells—The number of public servants has grown significantly from what it was in 1999. The Victorian Public Service wages bill is now \$12.2 billion. It is my understanding that, from 1999 to 2008, the Victorian Public Service has increased by between 64,000 and 65,000. We accept that there has been an increase of police of 1,400 and an increase of teachers and nurses of between 5,000 and 6,000, and we understand that there has been an increase in public health allied workers. But I am unsure of the allocation of employment in other sectors of the Victorian Public Service. All governments need and cannot function without a public service. So we support the strengthening of the Victorian Public Service; however, the question remains of where the allocations are for the 64,000 to 65,000 additional public servants in this state.

Senator FORSHAW—Over what period did that increase of 64,000 to 65,000 occur?

Mr Wells—That was from 1999.

Senator FORSHAW—So it is over the period of the Labor government.

Mr Wells—Yes, from 1999 to 2008. We are using ABS figures. There is one other system by which we can clarify, but the figure is between 64,000 and 65,000.

Senator BUSHBY—That \$18 billion increase in annual revenue since 1999 is an awful lot of money to be spent every year. It is just interesting to hear where it has gone.

Mr Wells—Yes, you are correct. The issue is that there has been a significant increase in the Victorian Public Service.

Senator FORSHAW—Could you give us a list of those major cost blow-outs that you have referred to that make up the \$5 billion?

Mr Wells—Yes, we will send that to the committee.

CHAIR—I am afraid I did not catch up with the budget. What was the publicised surplus in this last budget?

Mr Wells—It was \$828 million. The year before I think they were forecasting \$892 million; this year the surplus is \$828 million.

Senator FORSHAW—I am sorry; did you say it was \$828 million for 2007-08?

Mr Wells—It is for 2008-09.

Senator FORSHAW—So that is the projected figure. That is in the most recent budget.

Mr Wells—Yes. Graph No. 7 explains why we have problems with infrastructure in this state. We have spent less per head on construction than any of the other states has. Obviously, you would expect Western Australia and Queensland to spend more than us, but in Victoria we do not seem to spend the money on roads, bridges or tunnels. We do not build things or fix things. As a result, graph No. 8 shows that for anyone travelling on Melbourne roads—the Calder, the Monash or the eastern—there is gridlock. It is costing us and our economy millions and millions

of dollars because we are having trouble moving our products and our personnel around. Moving on to graph No. 9, Victoria is the red line.

CHAIR—I am sorry, I am one graph behind you. What does that show?

Mr Wells—This shows that on our main roads, in the morning peak, traffic travels at around 20 kilometres per hour and, in the afternoon peak, we travel at around 35 to 40 kilometres per hour.

CHAIR—So the figures represent speed.

Senator CHAPMAN—Is the speed on the left-hand side?

Mr Wells—Yes, the speed is on the left.

Senator CHAPMAN—This shows it at about 35 in the morning.

Mr Wells—Yes, 35. It is between 20 and 40.

Senator BUSHBY—That shows the average.

Mr Wells—Yes, that is the average. On graph No. 9, the red line is Victoria. That shows that we have the fewest hospital beds per 100,000. I suspect that is why we have a waiting list of close to 40,000. The document was released last week.

Senator FORSHAW—Is that per thousand?

Mr Wells—I am sorry; is it per 1,000 or per 100,000? It is per 100,000; I am sorry about that. A correction needs to be made to that. Thank you.

Senator FORSHAW—So that figure is 100,000 and not 1,000?

Mr Wells—Yes, I am sorry. That is per 100,000. They are building a brand new children's hospital, which will cost \$1 billion to \$1.1 billion, I suppose. Unfortunately, there only seem to be another 46 additional hospital beds for that Royal Children's Hospital. You would think that, if you were building a hospital for the next 25, 30 or 40 years, you would have the ability to expand. So the number of hospital beds per 100,000 is the lowest of any state, with the new Royal Children's only having an additional 46 beds.

Senator CHAPMAN—Is this per 1,000?

Mr Wells—I am sorry. It is per 100,000.

Senator BUSHBY—Can I just query that? I am from Tasmania, where we have only 500,000. That being per 100,000 would mean that Tassie would only have 10 beds. It must be per 1,000.

Mr Wells—I am sorry.

Senator BUSHBY—I do not mean to—

Mr Wells—Thank you very much. This was checked and double-checked and then, when I looked at it again, I thought—

Senator BUSHBY—Yes, I think that is right.

Mr Wells—Could I take that back? It should be per 1,000. The graph was right in the first place. We normally talk per 100,000 on everything, but it is per 1,000. I am sorry about that.

Graph No. 10 shows violent crime; it does not show total crime. We have a situation where your bicycles are safer in Victoria, but the reality is that these are the violent levels of crime such as rape and murder. In addition, we have had a significant increase in assaults, especially around our nightclub precincts. The amount of crime from 1999-2000 has increased from 31,000 to where it is pushing 42,000. As we say, the number of police on the front line has decreased. More police seem to be looking after prisoners in police cells, working on pet projects or doing administration, and that is not what the Victorian community wants.

Graph No. 11—moving right along—shows the OECD figures. They show that, of all the mainland states, Victoria for a 15-year-old has the lowest levels of reading, mathematics and science.

Senator BUSHBY—Is there any reason why it is only the mainland states? Were the figures not available—

Mr Wells—I am sure with the Tasmanian figures—

Senator BUSHBY—That would be the next along from Victoria.

Mr Wells—The next along.

Senator BUSHBY—Yes, I think we would be below. Our performance figures are pretty dismal down there.

Mr Wells—As a result, shown on graph No. 12, there is a significant shift of parents taking their kids out of government schools and putting them into private schools, including those in the Catholic education system. The government's No. 1 priority is education, so you would think that this graph would be reversed. Unfortunately, 8,500 students have been taken out of public schools and put into private schools, and there was a net decrease into government schools of around 220.

Graph 13 shows water investment. Victoria, like all other states, obviously has a significant problem. There have been suggestions that we should take water from Tasmania. We spend very little on water infrastructure. This graph, I suspect, will change when the desal plant comes on line. If the pipeline from the north comes on line, this figure would increase, but it just seems to be taking a significant amount of time to get water security for Melbourne and for Victoria. We are on stage 3A water restrictions, and I suspect that we will be on that level for quite some time.

Senator FORSHAW—Where is the desal plant being constructed?

Mr Wells—Wonthaggi.

Senator FORSHAW—It is to provide water for where?

Mr Wells—For Melbourne, and it will produce 150 billion litres per year. At this stage it will be a PPP project. If it rains, there are contingency plans to link it into the dams to fill them up. But that will cost around \$3.1 billion at this stage; we expect that to increase as costs move forward.

Senator FORSHAW—Does the opposition support that project?

Mr Wells—We support the principle of a desal plant.

Senator FORSHAW—Putting aside the costs and so on, you support—

Mr Wells—Yes, we support the principle of a desal plant, and the environmental standards are to be very strict around that desal plant.

The last graph is on the issue of housing affordability. The red is obviously the amount of blocks that are available; the blue line is obviously the population. We have a 2030 policy, which means that you have a ring around Melbourne and you cannot develop around that ring. As a result, obviously with supply and demand, supply is falling away, pushing the price of blocks up. So over the last few years blocks have gone from \$70,000 to \$150,000 and, as you can see, in 2006-07 the gap is widening when it comes to the amount of land available in comparison to population. That concludes the presentation. I hope that is of some value to your committee.

CHAIR—Thanks very much for that. We are running over time a bit, but we do have some questions for you. Can I perhaps start. How is the recent teacher wage increase being funded?

Mr Wells—In public accounts, as I explained, the budget was brought down on 6 May. My understanding is that they reached agreement with the teachers on 5 May, the day before, so it was not in the budget papers. The agreement was that the Victorian teachers would be the highest paid in Australia. We asked the Treasurer last week during public accounts for an explanation of how much it would cost and where in the budget papers we would find it. They said that they would take it on notice. The next day we asked Bronwyn Pike, the Minister for Education, the same questions. She was unable to provide the total cost of the deal. That was also taken on notice. So at this stage we have no information about the cost and we have no information about when the information to the public accounts committee will be received. So we are in limbo land, which is very disappointing, because, if you were signing off on an agreement of almost \$1 billion, you would expect that the figures would be available.

CHAIR—Is the private-public partnership for schools and hospitals unusual? Are you aware of whether that happens in other states?

Mr Wells—The principle is something that the Liberal Party supports. The school principals are very keen on it, because it means that a third party is responsible for the assets and the

maintenance and cleaning of the school, and it means that they are able to focus on education. So from a school principal's point of view, it is very attractive. Ironically, it is something that the state Labor Party totally opposed early in the piece, but they do now see the benefit of it. So it is something that both sides of the chamber support, and I suspect it will become more and more common.

CHAIR—In general terms, what net impact does that have on the budget? Is there a rent paid to the entity which owns the school? How does it operate? Are you familiar with that?

Mr Wells—It will shift from a capital component to a recurrent component, because there will be a leasing agreement over the life of 20 years, maybe 30 years, and then the school would then revert to being an asset of the state.

Senator FORSHAW—I have a couple of questions. I think you have dealt with this in some way and endeavoured to comment on it during the questions as we went through your presentation. You made the statement that Victoria was swimming in money. I have read your submission. I am still a bit perplexed at the situation you are putting to us that there is a huge increase in revenues but no substantial increase or any real expenditure on services and infrastructure. I am wondering just where all the revenue has gone. I know you have talked about the \$5 billion cost blow-outs—in the public service payroll, I assume—but I am still somewhat confused about that position.

Mr Wells—So are we. We had a budget of \$18 billion in 1999. It is now \$36 billion or \$37 billion, we now have a record level of taxation, we have identified \$5 billion of cost blow-outs on infrastructure projects and we have had a significant increase in the public service. We will wait now to find out the increase in debt levels and what that debt level has been tagged to for infrastructure projects. They were unable to provide that during the public accounts hearing, so that is on notice. We, hopefully, will have a better understanding of the tagging of that \$23 billion debt once we have those figures from the Treasury.

Senator FORSHAW—Have there been any reports, comments or observations from the Auditor-General in regard to the concerns about the situation you are expressing?

Mr Wells—The Auditor-General signs off on the budget papers, but I do not understand why they do that, because an audit is focused on historic figures. So why you would sign off on a budget is a concept I am still struggling with. He brought down a report just recently about water infrastructure. He was critical of the government in that they put together an infrastructure plan within six months. He made the claim that he did not believe it was well thought out—that it was more reacting to public pressure. So he did raise concerns about the methodology the government are using, for example, in water infrastructure. That is what he criticised just in the last couple of weeks.

Senator FORSHAW—What about the assertion you are making that it appears that debt has been raised and used for recurrent spending? I would have thought those sorts of issues would be something that a state Auditor-General might want to have something to say about—if it were occurring, and substantially so.

Mr Wells—Once we have the list from the Treasury about what the debt is tagged to, then we will be looking very closely at the capitalisation of maintenance moving forward. Those sorts of figures will be something the opposition will be very keen to look at.

Senator BUSHBY—Are you expecting that list?

Mr Wells—Yes, absolutely. We have no question about the list, but we are concerned about the level of detail that will be in that list. Once the list is produced then we can look at it and look at the issue of recurrent expenditure being capitalised.

Senator FORSHAW—I have two quick final questions. Your submission is also critical of the government—essentially that it is going to get itself into trouble or further trouble through excessive spending. You state on page 2:

At a time when the Federal Government is calling for fiscal restraint the Victorian State Government has embarked on a spending spree.

Then you go on to talk about rising interest rates, falling housing affordability and so on. Then:

... this Brumby spending spree is in direct conflict with the Federal Government's ... strategy.

That does not sit, at least to my mind, with your earlier criticisms that the government has been raising all these huge increases in revenue and not spending it on infrastructure or services—at least that is your assertion. But then you are saying that they are not actually going to do what you think they should have done and should be doing.

Mr Wells—That is a good point.

Senator FORSHAW—You are being critical, it seems, of their spending spree.

Mr Wells—The issue for us is this: if the money was being spent on items that were going to increase productivity, then that would have no or little impact on inflation. Our concern is that, if they are spending enormous amounts of money and they are not getting the productivity in return, then that is inflationary. I made points earlier in regard to the increase of the public service and an increase in cost blow-outs. If there is a return from a productivity point of view such that they are actually fixing roads, building bridges or building tunnels then you can see that there is a return on the state's investments. So we are very concerned about the way the state government is spending its money—that it is not focused on those items of productivity.

Senator FORSHAW—This is my final question. You referred to payroll tax—that there has been a cut in the rate but the threshold has not changed; it is still \$550,000. Do you have any comment to make on the federal government's recent announcement on increasing the threshold for the Medicare surcharge?

Mr Wells—I think the Medicare surcharge will have a phenomenal impact on the waiting lists in Victoria. As I mentioned earlier, we have approaching 40,000 people on the waiting lists. I think people bailing out of private health cover and going onto the public system will impact on us. In addition, as I mentioned in the graph presentation, we have the lowest number of hospital

beds per 1,000 head of population. I think that decision is wrong, especially for our state in Victoria.

Senator FORSHAW—Are you saying that individual or family taxpayers should not have their threshold increased as their income rises? A person on \$50,000 or a family on \$70,000 should continue to pay that surcharge and there should be no allowance made where incomes get above those figures—which are not high these days—but there should be an allowance made in the area of small business for payroll tax. Is that what you are saying?

Mr Wells—I think the issue of the Medicare threshold goes to what you expect as an outcome. My concern is that the outcome of that policy decision is that people will stop paying into private health funds—

Senator FORSHAW—I understand that side of it and I appreciate and understand the argument that is being put; whether I agree with it is another thing. Cost shifting has been going on for years and years in the health industry, and we can spend all day talking about that. But there is also this position: as long as the private health insurance rebate remains at 30 per cent and the cost of private health goes up, the private health funds get the benefit. The health funds see the actual amount of rebate going up, but the taxpayer—as they get into a higher tax bracket, through bracket creep or whatever—ends up getting hit with the surcharge. That is because it is not being adjusted upwards, as we expect to happen in every other area.

Mr Wells—I understand your point, but—

Senator FORSHAW—I know you do.

Mr Wells—I bring it back to what the outcomes and objectives of the government are. The concern from us as Victorians is that, if there is an incentive for people to stay in private health funds, they will go to private hospitals. But, if the young, fit and single people are going to bail out of private health cover and go into the public system, it will mean longer waiting lists and an increase in health costs. In addition, it means that your health funds are going to have the older people, who are more likely to get sick. So I understand your argument about the payroll tax threshold, but it goes to what the government wants as an objective and a goal.

Senator CHAPMAN—You have indicated that at this stage you do not have any firm information as to the way in which the debt was being used, whether it was being used for long-term infrastructure or recurrent spending, but you suspected that it was being used for recurrent spending.

Mr Wells—As I mentioned earlier, we are very concerned that, if some of the maintenance of some of the larger projects has been capitalised over four years, instead of it being recorded as a recurrent expense it will be capitalised and the government will argue that they can loan against that capital item—and that is wrong. So, when we get the lists from Treasury, we will be keen to follow that through.

Senator CHAPMAN—Can you tell me how the government debt projection of \$9 billion by 2011, which you have quoted, compares with debt during both the Kennett and the Kirner years, firstly, as a percentage of state revenue and, secondly, as a percentage of gross state product?

Mr Wells—Those figures are in the budget papers and we can get that for you. But the reality is that we have concerns about the rapid increase from \$3.5 billion in 2002 to the \$23 billion by 2012. We are also concerned that there is no debt plan in place for how it will be repaid. They talk about debt profile but, as I also mentioned, you have a debt interest servicing cost of \$1.8 billion, which is also of concern. Talking about percentages of GSP, the government is very keen to chop and change to whichever percentage suits the argument of the day. The reality is that, when the Kennett government came in, we had a debt of \$33 billion, and that was by far a greater proportion of our GSP in those days. But, when you start to shift debt from the government sector to the water authorities and the port authorities, that is reason for concern.

Senator BUSHBY—Is the government taking dividends from the non-general government sector in Victoria?

Mr Wells—The government is taking significant dividends from the water authorities and at the same time is forcing the water authorities to increase their debt. The dividends from the water authorities run into hundreds of millions of dollars, and we will get an exact figure. But it does seem ironic that the water authorities are being charged the dividends and then being expected to build infrastructure. You would expect them to use those retained earnings to build infrastructure. \$2.4 billion in dividends is coming from the water authorities—which is ironic, as I said, because you would expect those retained earnings to be used for building infrastructure, such as dams and pipelines—which is increasing their debt significantly.

Senator BUSHBY—Is the rate of the dividends that are taken set by the government, or are they based on a percentage of profit?

Mr Wells—They are set by the government.

Senator BUSHBY—They are set by the government, regardless of performance?

Mr Wells—Yes.

Senator BUSHBY—You have mentioned that they are raising debt at the same time. Are they raising debt as a result of the requirement to pay dividends to the government?

Mr Wells—That is another line that we will be investigating, because that is an obvious question: are you increasing your dividends at a time of increasing debt and are you using part of that debt, in theory, to repay some of your dividends? It is illogical to argue that, but it is something that we will need to follow through very closely.

Senator BUSHBY—Asking the same question in a slightly different way, just trying to get a slightly different answer: does the fact that the government is taking dividends out of those authorities hamper their ability financially to deliver the services that they are required to deliver?

Mr Wells—I think the Melbourne water authorities deliver a good service; the reality is that there is not the infrastructure to support them. We have pipelines that are crumbling. We have lack of infrastructure. If the infrastructure were in place, like the desal plant, it would assist the

water authorities. But we are not seeing that at the moment. There are lots of promises and plans, but we will wait and see what occurs over the next couple of years.

Senator BUSHBY—So theoretically, if the dividends were not being taken out, those water authorities would have more scope for maintenance and development?

Mr Wells—Yes. That is the logical conclusion that you would draw—if you were able to use some of your retained earnings, you would be able to make decisions more readily to build the infrastructure. But, if we are relying on the government—

Senator BUSHBY—It removes flexibility.

Mr Wells—Yes, it removes flexibility.

CHAIR—Just before you move off that point: do you think those public authorities should be paying a dividend to a government, or should they be using all of their profits to reinvest in additional capital works?

Mr Wells—I think one of the most significant problems this state has is lack of water. You would think—as Senator Bushby said—that the water authorities should be able to use retained earnings for greater flexibility to build things to provide greater security of water. I do agree that the water authorities should be paying a dividend to the government; however, in the current situation, where we have a significant problem with water, you would think that you would revise the amount of dividends that are being paid by the water authorities to the government, which would allow them to use that money for greater flexibility.

CHAIR—I do not want you to make a policy announcement on the run, so you may decline to answer this: as an alternative government, is there a rationale for getting a dividend from public authorities? Why are those public authorities—the water we drink, the sewage we dispose of and whatever else you do in Melbourne—used as part of the revenue raising of government? As I say, I do not really want you to commit yourself unless you are in a position to do so. I just wonder what the alternative government's view might be on these sorts of things.

Mr Wells—It is unwise for the opposition to make any comments about policies, because we do not know what the financial situation will be in 2010. So we do not talk about tax reforms and we do not make those sorts of commitments. I think water authorities should pay a dividend, but I also think that some common sense should be applied. If your infrastructure is crumbling around you, you should be able to say to the water authorities, 'That dividend will be reviewed or suspended,' to allow the water authority to use retained earnings to build that infrastructure.

Senator CHAPMAN—Most private corporations would retain part of their profits for expansion, growth, development, new equipment or whatever, and part would be paid as a dividend. So you would expect the same would be appropriate for a public corporation.

Senator BUSHBY—They would not be paying dividends to shareholders if they were making a loss, either. Given what we have heard from you about the increased revenue and the increased spending that is matching it constantly—and there is a bit of a fuzzy area as to where some of that is spent and whether it is on recurrent expenditure or infrastructure—how exposed do you

think the Victorian budget would be to a downturn in economic circumstances? Is there any flexibility, as you understand it, built in?

Mr Wells—I am very concerned about the reliance of the state budget on property taxes. I think the reliance on land tax and stamp duty was in the high teens in the late nineties; now the percentage is in the very high 30s. With increased interest rates, petrol prices, the CPI moving and pressure from overseas markets, my concern is that, if the property market is hit and there is a slight downturn, there is going to be a significant impact on the Victorian budget because of its heavy reliance on property taxes.

Senator BUSHBY—Presumably GST and other aspects of an economic boom would also turn it around a bit and affect it as well. Going on from that, given the revenue that has been available in the last 10 years and the demands for services that the government have had—and I know they have not met a lot of them according to what you have said—do you think there was scope for them to have planned ahead for bad times by putting budgets away in funds or investments and building a reserve fund so that they could ensure that when bad times come they could continue to operate without any reduction in services?

Mr Wells—Had the economic situation that has been bestowed on this country and the money that came from it been used by the Victorian government to build things and to fix things, then we would have been improving our productivity. So when the bad times came at least we would have been improving our productivity or increasing our base for manufacturing, for example—being able to get our containers off the wharf, being able to move our products and our personnel around the city and the state. But because we have not done that, we have not prepared for the bad times that will obviously come at some point.

CHAIR—Finally, did you say in your evidence that the Victorian government are borrowing \$3 billion to pay the wages of nurses, teachers and police, or were you making the point that they are paying \$3 billion in interest, which would be enough to pay those wages?

Mr Wells—That was in 1992, when the Kennett government first came to power.

CHAIR—Really? We have run out of time, unfortunately. Thank you very much for that and for the graphs you have supplied us, which I find interesting. The health system in Victoria, according to those graphs, is worse than Queensland's—and I find that impossible to believe! It must be terrible here if that is accurate, and I am sure it is. Thanks very much for coming along.

Mr Wells—Thank you.

CHAIR—I am very keen to get our next witness to the table. Kim, you might be interested that Professor Davidson is suggesting that income tax be returned to the state. I am not going to ask you about that! But I am fascinated to hear Professor Davidson.

[11.50 am]

DAVIDSON, Professor Sinclair, Senior Fellow, Director of States Policy Unit, Institute of Public Affairs

CHAIR—Good morning, Professor Davidson. Thank you very much for coming along. I am sure you have appeared at committee hearings before and you are aware that these are proceedings of parliament and are subject to parliamentary privilege. I do not think there is really much else I need to tell you. If any of the contingencies that I should warn you about arise, I will do that at the time. I do not think we will need to have any of your evidence in camera. Thank you very much for your submission, which I found very interesting. It is a pleasure to have you with us. Do you want to make an opening statement?

Prof. Davidson—Yes. Thank you very much for having me. My intention this morning is to speak to the paper and amplify some of the points and comments. If I may, I will add an IPA paper from 2006 called *Opportunity squandered: how the states have wasted their reform bonus*, which will add some substance to what I am saying and also some substance to what Mr Wells said previously. As I said, thank you very much for the opportunity to speak. There are two points that I really want to pick up on. The first point is the issue of government debts. We have heard that state debts have increased and that is the case over time. The second point that I want to touch on is fiscal federalism, which I understand would not be a popular suggestion at this time but hopefully in future would become more valuable.

The argument that we want to make about state debt is that the IPA totally approves of the various governments of Australia having low levels of debt. We do not subscribe to the lazy balance sheet theory where people argue that companies should have substantial amounts of debt on their balance sheet working for the shareholders, and that governments are then in equivalent positions and they should have substantial amounts of debt on their balance sheets. Our argument fundamentally is that private debt is paid out of voluntary transactions. State or government debt is paid out of taxation, which is coercive. Taxation is associated with deadweight losses, which as a rough and ready guesstimate is about 20 per cent. Every dollar of taxpayers' money spent costs \$1.20 to raise in opportunity costs. That is a guesstimate. In fact, the deadweight losses of taxation must be determined at the time. Future taxpayers paying the taxes associated with interest payments are each associated with their own deadweight losses and we in the present cannot forecast what they will be in the future. So the debt burden of state or even federal government debt is actually borne by future taxpayers; it is not borne by the current generation. That basically means that debt should be used sparingly. It should be used when there are unambiguous benefits from that debt. It should be used for self-funding projects. That is our argument, so we totally approve of low levels of debt at the Commonwealth level and at the state level.

Levels of debt in Australia at the moment tend to be fairly low, and that is because of conscious decision making by governments to lower debt. Having a look at Australian Bureau of Statistics data, their argument is that all levels of government, when we add everything up, is a net lender. That is not the case at the state level where some of the states are actually net borrowers.

Senator BUSHBY—Which ones are they?

Prof. Davidson—New South Wales, Queensland and South Australia at the non-financial public sector level and New South Wales, Victoria and Queensland at the total public sector level are net borrowers. That all adds up to \$9.7 billion according to the latest ABS figures, which came out before the most recent budget round. I was very shocked to see that Victoria's level of debt would be ratcheting up to \$24 billion over a three-year period. That is an astronomical amount of money to be borrowing.

However, when you have a look at the total magnitude of debt across the entire system, including the Commonwealth government, the total public sector is still in surplus. If we are talking about state government debt causing macroeconomic problems in Australia, the entire government sector combined is in surplus. Our argument is that it is possible that debt could cause problems. It is possible we could point a finger at all the state governments and say, 'You guys are doing a terrible job.' As Mr Wells indicates and as the paper I put in as evidence indicates, state governments are misallocating capital. There is no doubt about that. They are spending unwisely. They have blown up their payroll budgets and that sort of stuff. But I cannot honestly say that this is causing fundamental macroeconomic dislocation in Australia. They are not a cause of inflation, in my opinion, in Australia today.

Senator BUSHBY—Surely though, if state governments are spending more than that is adding to the economic activity which adds to the overall inflationary pressures, for want of a better way of putting it?

Prof. Davidson—Inflation is a monetary problem; it is not a spending problem. Misallocation of capital does not cause inflation; expanding the money supply causes inflation. If we have look at RBA figures over the last year or so, money supply is growing at a much higher level now than what it was even a year ago. That is a function of things such as the massive increases in business borrowing that occurred over the last year, which occurred via the banking system as opposed to via the markets. Those sorts of things are adding to inflation. State governments have been increasing their debt now for a long time—let us be generous and say eight years. Inflation has emerged as a problem over the last six months, so it is not clear to me.

Senator BUSHBY—But if the Victorian government—since we are sitting in Victoria—came in with a budget surplus of \$10 million and put that away in a fund to fund things off the interest or whatever and they took that \$10 million out of the economy, would that reduce inflationary impact?

Prof. Davidson—In my opinion, no. As I said, misallocation of money does not cause inflation. Subsidising future government spending also does not cause inflation or detract from inflation. If there was enough government debt around so that the entire Australian government sector was in deficit and somehow the Reserve Bank were monetising that deficit, that would cause inflation. So it is quite possible that phenomenal levels of debt at some future point could cause inflation. There is a potential but in actual fact that problem that we are talking about has not yet occurred. But I would not try to use fiscal policy to try to manipulate inflation. That is a monetary problem and the Reserve Bank deals with it. When inflation breaks out, it is the Reserve Bank's fault; when inflation calms down, it is Reserve Bank's job to do that. We should let them do that.

Senator BUSHBY—I know this is not the subject of today and if you do not want to answer it you are free not to: do you think the federal government attempting to show fiscal restraint would have any impact on inflation at all, given what you just said about fiscal policy?

Prof. Davidson—The budget of last week is going to have very little impact on inflation. As a matter of fact, despite the Treasurer having said that there should be spending cuts, there was actually a one per cent spending increase. But it is a very mild effect one way or the other. The Reserve Bank does not need the federal government's help in maintaining inflation as long as the government's budgets are in surplus. Yes, I am a surplus-monger. Our argument is that there is a potential for this to cause macroeconomic dislocation. But on the ABS data that we looked at, which came out earlier this year, the overall total public sector is in surplus so we are not overly concerned that.

To pick up then on some of the questions that you were asking Mr Wells, a matter which I think is of great concern is the idea that government instrumentalities would be borrowing money and then paying dividends out of those borrowings. That is also something that I have thought about as a way in which you can transform debt which should be used for capital purposes into current consumption. That is a potential problem. So I had a look at some of the Productivity Commission reports on government trading enterprises. They tracked 85 different organisations across Australia. Unfortunately, the PC data is not as valuable as it could be, especially as there is an accounting change in the last year of their analysis. I asked the Productivity Commissioner, who is responsible for this, 'Is this a serious accounting change or not?' He said it is really quite serious and we cannot compare previous data to each other. I have collected the data for Australian state owned enterprises, put it into different categories and shown, on page 3, their return on assets, their cost recovery figures, their debt to total asset figures and their dividend payout ratios. The dividend payout ratio that immediately jumps out is the 440 per cent in urban transport.

CHAIR—Just for my understanding, could I ask: the dividend ratio is what to what?

Prof. Davidson—The dividend payout ratio is the dividend paid to the net earnings of the organisation.

CHAIR—Thank you.

Prof. Davidson—I can probably get you a far more precise definition, if you want it.

CHAIR—No, that is fine.

Prof. Davidson—The one that jumps out there is the 440 per cent, but that is a one-off that is associated with the privatisation. So that number is an anomaly. If you look at all the other urban transport entities reported on by the Productivity Commission, none were paying any dividend at all. That also is not surprising because, looking at the column headed 'cost recovery', urban transport entities are not covering their costs. They should not be paying dividends and, generally speaking, they are not. The other one that should not really be paying a dividend is railways, with a cost recovery of approximately 94 per cent. Railways has a dividend payout ratio of 10 per cent. That is also probably one that somewhere along the line is making money, but that is not a—

CHAIR—I am sorry; with the cost recovery, less than 100 is—

Prof. Davidson—Yes, they are making an accounting loss. That is the data that I looked at. Ideally, we must bear in mind that, yes, these are government instrumentalities that are borrowing money and paying dividends, but these organisations really fit into the category of organisations that trade. They are government owned, but they are not in business to provide welfare, subsidies or anything along those lines. These are trading organisations that could, in principle, be privately owned.

So, in considering these firms, the benchmark is: what do other privately owned firms like these actually do? I looked at the OSIRIS database, which covers about 100 different economies and contains about 100,000 different firms, and I separated out those firms that are described as utility stocks or utility firms. Unfortunately, most of these firms tend to be concentrated in the United States and the United Kingdom, and it is quite hard to get a nice comparison sample for all of these different firms; so the analysis that I did was very rough and very ready.

The return on assets for these firms, on average, was about four per cent, which compares approximately with the Australian firms. Their dividend payout ratios were 61 per cent, which is slightly lower than that of some of these we are looking at here. However, Australian private firms do actually have higher dividend payout ratios than their US and UK comparators. To a large extent, that is because of the dividend imputation system. These firms are not taxed. Nonetheless, Australian firms would have a slightly higher dividend payout ratio, which is what we observe here.

The debt to total assets ratio is 34 per cent for the UK and US firms. With a rough and ready look at that sort of thing, it is in the same sort of ballpark figure. Again, I am not overly concerned, as this is a back of the envelope type analysis. On the back of the envelope, looking at these corporations with the data provided by the Productivity Commission and looking at comparator firms, it does not seem to me that there is anything untoward going on here—but that is not to suggest that it is not.

Certainly, I would suggest that the Productivity Commission be asked to undertake a far more detailed empirical analysis because, with sufficient data, an econometric model could be specified to predict what the debt asset ratio should be. The Productivity Commission has the resources and the human capital to undertake such analysis; therefore, it could do an analysis to come up with the range of debt to asset ratios that these firms should have.

That analysis can be done similarly with the dividend payout ratio. If you have the underlying financial statements—which, unfortunately, are not in the public domain—there are econometric models that can make predictions. A far more detailed analysis could shed light on this; but, just on a rough and ready basis, I am not overly concerned at these numbers, which are slightly different to my expectation.

What does concern me, however, is that these state owned enterprises borrow money using the state's AAA rating. These firms themselves are not AAA rated. Depending on which state they are incorporated in, their state government may require them to calculate what their stand-alone rating would be and, for competitive neutrality reasons, to pay the difference into the government. I think that is all very well and good. At the same time, however, there is an implied

subsidy here over and above the competitive neutrality issue. I think state governments should be required to place this debt on their own balance sheets as a contingent liability to simply say, 'Our state owned enterprises do have these levels of debt.' That would really add transparency for the taxpayers and the citizens of the state to observe what is going on and what is implied. I would imagine that most of these firms would be reasonably stable, with good solid cash flows. The probability of water or electricity defaulting must be very minimal; nonetheless, it is—

CHAIR—Didn't you have problems with your trams here, in Victoria?

Prof. Davidson—The railway system, yes.

CHAIR—My knowledge of Victoria is not good, but I thought you had private trams that lost so much money they were taken over by the government.

Prof. Davidson—No, I do not think it was the tram system.

CHAIR—The railways perhaps.

Prof. Davidson—One of the railway companies abandoned their assets and returned them back to the government; that is true. However, you will notice that I did not actually say 'urban transport'. Water and electricity, I would imagine, would be fairly stable. Urban transport are not covering their costs. Railways also, surprisingly, are not covering their costs. We hear a lot about the need for infrastructure in railways, yet they do not cover their costs. Today, the lead story in the *Financial Review* is that the Adelaide-Darwin rail link is in financial difficulty. So the need to expand rail infrastructure is not immediately obvious from that sort of story.

CHAIR—I am sorry; there is no differentiation in your figures on rail regarding passenger and urban as opposed to freight.

Prof. Davidson—No. Urban transport would be city based rail and railways is—

CHAIR—Long distance and freight.

Prof. Davidson—Yes. Unfortunately, there are different ownership relations between the states and what have you. The Productivity Commission gives a break-up for each of the 85 followed but, again, unfortunately, that data is for 2005-06.

Senator FORSHAW—Can I just clarify something? I am not an economist or an accountant, but are these direct costs?

Prof. Davidson—Yes.

Senator FORSHAW—They do not factor in any other cost benefit—

Prof. Davidson—No.

Senator FORSHAW—such as rail versus environmental considerations and all those sorts of things, or public transfer versus—

Prof. Davidson—No, they do not do that. This is an evaluation of state owned enterprises as of—

Senator FORSHAW—I assumed that they were private, but I just wanted to get that on the record.

Prof. Davidson—Yes. Those arguments need to be considered as well, but that is not what is here.

Senator FORSHAW—I understand.

Prof. Davidson—Just to summarise very quickly: we approve of low government debt and we approve of budget surpluses. We recognise that state government debt could be causing a problem and it is a potential problem, but as yet, in our opinion, it has not occurred. We also believe that the Productivity Commission could undertake a far more detailed analysis of the data that they have in order to reassure the public that these numbers are appropriate. However, from eyeballing these numbers, I am not overly concerned about where they stand at the moment. That led us to think about issues of federalism.

CHAIR—Before you continue—I should have asked you to do this before—although all of us here are familiar with the IPA, could you tell us, for the record, what the IPA is and where you fit into it?

Prof. Davidson—I am a professor of institutional economics at RMIT University, and I am also a Senior Fellow at the Institute of Public Affairs. I am on secondment from RMIT University to the IPA this academic semester. The Institute of Public Affairs is a free-market think tank based here in Melbourne, and we promote small government, private capital markets.

CHAIR—Thank you very much. You may proceed to section 2 of your paper.

Senator FORSHAW—We do not have any senators with a conflict of interest to declare, do we?

Senator CHAPMAN—I should declare that I am a member.

Prof. Davidson—Thank you very much, Senator.

Senator FORSHAW—I would have been shocked if you weren't, Grant.

Prof. Davidson—The difficulty facing state governments in Australia is, as Milton Friedman said: 'You can spend your own money on yourself. You can spend your own money on somebody else. You can spend somebody else's money on yourself. You can spend somebody else's money on somebody else.' As it happens here, in Australia, state governments are spending somebody else's money on somebody else. The federal government raises about 80 per cent of all revenue in Australia and the state governments, depending on which area, spend up to 60 or 70 per cent of the money. What in fact happens is that we have this large transfer of funds from the federal government to the state governments. They are spending somebody else's money on somebody else. So it is unsurprising that we might see areas of waste and

misallocation of funding and what have you. The states do not bear the costs of raising the money that they raise. The federal government does that.

Australia is a federal system, so we actually expect to observe some sort of vertical fiscal imbalance. The economic literature on federalism normally argues that we should push up taxing powers because that gives us a broader tax base and that we should also push up public spending because that gives us the certainty that a citizen anywhere in the state, anywhere in the geographic area of a federation, would have the same level of public service spent on them as any other citizen.

That is all very well and good, except that economists tend to have a very generous definition of what is a federal system. Economists would define, for example, England as being a federal economy because it has regional authorities that have some level of authority and decision making. What is a political federal system and what is an economic federal system is very different. I think we need to recognise that, if we live in a political federal system, there are costs and benefits associated with that. One of those costs, certainly in Australia, is a huge amount of vertical fiscal imbalance.

I would like to build on the late George Stigler's principles of government where he said: 'Representative government works best the closer government is to its constituency.' I am sorry to be saying this to federal senators—I am sure you do a wonderful job. But certainly representative government should be closer to its constituency rather than—

Senator CHAPMAN—We represent the states. It is all about state service.

Prof. Davidson—Indeed, yes. Thank you. Also, the subsets of voters in each of these states should have the right to vote different amounts of public services for themselves. The argument is then that we need to somehow empower those subsets of voters to do things for themselves. What has happened in Australia is that, over time, the states have become less able to raise their own funding. You can tax wealth, you can tax income, you can tax consumption or you can tax transactions. Taxing transactions is probably the most inefficient way of doing things. State governments are left in the position where they can tax transactions and very little else. Taxing wealth is also inefficient. Competition in Australia has led to where we do not really tax wealth. We tax income, and we tax consumption—which is the GST.

Our argument is that we should push down some level of taxation. Within Australia, if we think back to the Australian Constitution and what it is designed to do, it is effectively designed to create a common market within the six former colonies and the territories, which basically means that the Commonwealth or the federal government should be looking after common market activities. It should be looking after corporates, which it does, and therefore our argument is that the Commonwealth should retain the corporate income tax power. But individuals are located within states and therefore the states should have the personal income tax power.

This is not a new idea at all. I was reading Julie Smith's book *Taxing popularity: the story of taxation in Australia*, which is a very nice little history of taxation in Australia, and she actually mentions that this idea was first put forward in about 1916 or so. This idea has been around for a long, long time. I have also read some debates in Australia after the Second World War, in the 1950s, where people were saying that the states should have income-taxing power. This is not a

new idea and we are not claiming originality, but we certainly think this is something which needs to be thought about. The states would have income tax power, taxing individuals, and the Commonwealth would have corporate tax power and would also regulate corporations, which is what it does under the Constitution.

Of course, there are a number of objections to this I am sure. We are not proposing that the Commonwealth simply give the personal income tax money to the states, as it does the GST. We actually think that, if you are going to have people spending their own money on somebody else, the states actually need to raise that money. There is also the question of what you could do or not do about income tax imputation—you can still keep the imputation system if you like. The imputation system only takes out about a third of corporate tax income that gets raised. The other two-thirds are actually never really used. So you could keep that. There may be difficulties with the Australian Taxation Office enforcing state government laws. I am sure schemes can be devised to allow that to happen; that should not be too difficult. Federal courts enforcing state laws might also be a problem, but there are always ways in which that can be organised. Of course, the states themselves might not want to have that responsibility. After all, simply spending money is a very desirable state of affairs. I know they complain bitterly, but spending other people's money is actually a good thing compared to bearing the pain of raising the money themselves. Thank you.

CHAIR—Thank you very much for that, Professor. As I said before, I found your paper and suggestions fascinating. I am sure we have all got a lot of questions, but unfortunately we are almost out of time. I am indicating to my colleagues that we should be relatively brief and perhaps pick out a couple of questions from the many that we wanted to ask. I will do that, but I will do it last.

Senator CHAPMAN—Accepting the principle of what you say, my recollection is that the Fraser government actually legislated to allow state governments to collect income tax but none of them wanted to pick it up.

Prof. Davidson—Yes.

Senator CHAPMAN—Do you think the political argument could be won on that issue and, if so, how?

Prof. Davidson—I think the argument needs to be made around all the talk we hear about federalism, new federalism, buck-passing and all that sort of stuff. Certainly, the debate as we see it seems to be that the Commonwealth government should be taking over more and more authority, for example, over the health system. Part of the difficulty is that the Commonwealth government has all the money. There was an article in the *Weekend Australian* by George Megalogenis where he actually suggested that the Commonwealth government basically keep all the money that it currently spends on health and simply allow the state governments to dip into that—they would simply be service providers. That simply seems to be that decision making is being pushed up; whereas in representative government you want to push decision making down.

The difficulty with the Fraser government was that states were given the option of raising an income tax if they wanted to. Clearly, raising an income tax does have costs associated with it

and does make state government harder. But I think that, if we want responsible government that does not fritter away money, we need to say to them, ‘You have a choice: you can have no money or you can have your own income tax power.’ The federal government actually has a lot of authority in this area to exit. That is certainly what we are proposing. I know it makes life hard for you as well. I am not doubting that for one second, and I am not doubting that you do not necessarily want to hear that, but this is an opportunity to experiment with our fiscal system. The state governments are becoming more and more redundant, but they still have a lot of spending power under the current system. Our proposal has the advantage that you do not have to make these arguments that a lot of people make about getting rid of the states, which is simply nonsense. That is not an argument that is ever going to happen. The argument that we need to get rid of one level of government is simply not a starter.

Senator CHAPMAN—You also indicated that overall the states were not in a net debt position, but that several states were.

Prof. Davidson—Yes.

Senator CHAPMAN—Have you identified the reasons why those states that are in a bad position are in that position?

Prof. Davidson—No, I have not looked into the details per se. If we have a look at the Australian Bureau of Statistics data, it suggests that New South Wales is in deficit on general government. That is actually its day-to-day running of government. Looking then at what the Australian Bureau of Statistics called non-financial public sector—that is, the general government plus its utilities—New South Wales falls in there again, and then Queensland and South Australia. The Queensland and South Australian utilities are actually losing money. At the total public sector level—that is, general government plus utilities plus some financial corporations which they own—New South Wales is still there. Victoria now comes in and Queensland comes in as well. Except for New South Wales, where it is actually its general government that is the problem, the difficulties for the other two states are coming in in their instrumentalities. I have not actually drilled down into those.

Senator FORSHAW—Just on your suggestion about the states getting income-taxing powers, would you favour a situation where it was a consistent set of rules regarding the imposition of income tax and what was allowable and what was not, or should it be open to states to have differences?

Prof. Davidson—Ideally I would allow it to be open to states to have their own variations on a theme.

Senator FORSHAW—As they do in some other areas of corporate tax.

Prof. Davidson—Yes. There may actually be some population movement around that, and that is normally the argument—that there would be a race to the bottom. Yet if we look at the Swiss, who have a confederation, and their cantons, some of the richer cantons actually have higher levels of taxation than others and the rich are not stampeding out of the doors. People actually trade off tax against what they are getting.

Senator FORSHAW—It is not that far to travel, though.

Prof. Davidson—Yes.

Senator FORSHAW—It may have something to do with language, too. There are more French speakers in the south and more German speakers in the north.

Prof. Davidson—Yes. But even within that you do not have as much—

CHAIR—But they would have much better services in those high-taxed, wealthy cantons, wouldn't they?

Prof. Davidson—Yes, they do, and that would be the argument here. The state government would be bearing the cost and having to deliver the service.

Senator FORSHAW—They would go from four stars to five stars.

Prof. Davidson—A priori, I would allow each state to have its own taxation, but I imagine that over time they would tend to harmonise, as we observe.

Senator FORSHAW—I was thinking about this when you were talking about getting representation and decision making closest to the people. Do you have any comment about the role of local government in the current arrangements and in future arrangements? One of the critical issues for state governments—and, to some extent, for the federal government—is the whole role of local government. We are seeing in my own state and in other states constant growing arguments about how far councils can continue to control planning. They are always saying that they are short of funding—and I declare an interest; my wife is a local government councillor—but it is an increasingly important area of debate within the state government itself.

Prof. Davidson—The argument that we tried to make was an argument about how to do something about states that was consistent with the Constitution. Local government is not a recognised level of government in Australia.

Senator FORSHAW—I understand all that. I know you are not trying to suggest that they get taxing powers, but we cannot forget in this inquiry that local government is there and has a role to play in relation to both federal and state government.

Prof. Davidson—Speaking about here in Victoria, local government do have difficulty as to where and what they are and where they fit in and what have you. My perception is that local government collect garbage and prevent development. I have not followed this very closely, but my perception is also that most local government prevention of development gets overturned at a higher level by the state government. So at the moment they are creating—

Senator FORSHAW—I know we are short of time, but there are local government areas in New South Wales, for instance, and I assume in other states, that have bigger budgets—maybe as big as the ACT—where they are delivering a whole range of services and they are also competing with the private sector, whether that is in child care or various social sectors or in road funding.

Prof. Davidson—I would say the biggest problem facing local governments is the geographic difficulties of Australia. We have most people living in capital cities, where local government is really a nuisance, compared to people living in rural areas where local government can play a much bigger role. Whereas I would rather deal with my state member of parliament than with my local councillor, I think in a rural area you would have more representation through your local government than you do through your state member of parliament. I do not know if there are any quick fixes as to how to do that or to create regional authorities—

Senator FORSHAW—You mentioned England. One of the interesting things there is that their local councils have quite a lot of the authority and deliver a lot of services that state governments do here. I know Senator Macdonald will probably want to talk about the Brisbane City Council, so I will leave it at that.

Prof. Davidson—We have a very different geographic issue to them.

Senator BUSHBY—I am interested in this federalism debate that you have raised and the issues that you put forward. As a senator from a smaller state, I have some considerable concerns about the centralisation of a lot of functions of government that is being talked about, and I would not like to see too much of that happen. This certainly presents one option of preventing that. One thing that does concern me about your suggestion here is the issue of addressing horizontal fiscal equalisation. How would that fit into what you are proposing?

Prof. Davidson—The arguments there are in economic literature and they are saying that a citizen should be geographically located anywhere and get the same public good. The argument really becomes: what is a public good? If you take a narrow definition, public good is things such as national security, policing, all of those sorts of things. My argument has no impact upon that. If you take the view that a public good is welfare—it certainly would not be the way an economist would describe it, although a lot of laypeople would describe it as that—you would see that some areas would experience declines in welfare and other areas would not. But the taxing and spending arrangements of the state would have to reflect that. So if you lived in a state that had a higher preference for welfare, you would have to have higher taxes. That would be a difficulty. How much more of a difficulty than we currently have is not immediately clear to me.

Senator BUSHBY—I have a specific example where you might have cantons that are higher taxing but have higher services. This has some concerns for me, from a smaller state's perspective, because those who have the lower services and the lower taxes may find they have an inability to raise taxes to meet the services and it may be a self-fulfilling draw to the wealthy people with wealthier cantons.

Prof. Davidson—However, the mobility of the population can change that. That is not overly problematic, I would have thought, because the population would move to reflect those sorts of changes. My perception at the moment is that the Australian population tends to be less mobile; people do not want to move too far from where they grew up. That may be untrue, but it is certainly my perception.

Senator BUSHBY—That is probably more true in the bigger cities than it is elsewhere.

Prof. Davidson—Yes.

Senator BUSHBY—You mentioned that, in terms of macroeconomic dislocation in the economy, the overall net debt situation of government in Australia does not present you with too many concerns at present. In particular though, on the current projections from the Victorian budget papers of the additional \$24 billion, I think it was, over the coming years: how does that feed into your assessment of that—particularly if that is reflected in other states?

Prof. Davidson—I would have thought that \$24 billion would certainly turn the overall positive into a negative. If the other states follow that, it will all become a negative as well—and that would be concerning to me. That does have the potential to cause problems. The historical record up until now is, I think, fine. But looking forward—

Senator BUSHBY—That is in their budget papers as ‘forward estimates’.

Prof. Davidson—Yes. In fairness to the Victorian government, that \$24 billion might not materialise, given that the government salted away \$40 billion to spend on this sort of thing in last week’s federal budget. I am not quite sure yet how those budgets interact. The \$24 billion does look problematic to me.

CHAIR—I have two quick questions. If the states had their own income tax from personal income, how would you, in practical terms, look after states which do not naturally have the same wealth?

Prof. Davidson—The federal government still has the power to provide funding under the Constitution. The income tax power would be the bulk of the money, but the federal government would still have the GST, which I expect it would continue to distribute as it currently does. The federal government would still be raising corporate tax. For a lot of what the government raises money on, it actually ends up giving it to the states anyway. There would still be that ability. I have not called for the Commonwealth Grants Commission to be abolished. So there would still be some ability to—

CHAIR—So, you would do your vertical fiscal imbalance out of the revenue from corporations?

Prof. Davidson—Yes. But it would still be somewhat different from what it is now. The states would still have the ability to ramp up or down, as their local voters wanted. The Commonwealth would still have the ability to distribute money. The Northern Territory, for example, might need more top-up money than Tasmania.

CHAIR—Was it you or another submitter who said that the Commonwealth did have a discretion with GST?

Prof. Davidson—No, it was not me.

CHAIR—Okay.

Prof. Davidson—I am not suggesting any change to the GST.

CHAIR—I do not think it can be changed by the Commonwealth alone.

Prof. Davidson—I will just say on the record that I think the current GST arrangements are very good because they lock in place that the GST rate will not change. The Commonwealth bears all the costs of raising the GST and the states get all the benefits from it, and there is no reason for a Commonwealth government to incur the costs of changing the GST. Unlike so many other governments where a consumption tax gets introduced at a low level and then is ramped up, Australia has not seen that. I do not think we will see that, and I think that is a good thing.

CHAIR—You did not listen to our rhetoric before the election when we said that, if all the states and the Commonwealth were held by the same political party, they could put it up.

Senator BUSHBY—They probably couldn't.

Prof. Davidson—They probably could but it—

Senator FORSHAW—It causes disbelief to suggest that all state governments will agree with the Commonwealth, irrespective of what party they are. They are more likely to argue.

CHAIR—Professor, you mentioned in your paper and today that, on a cash-operating basis, the public sector position of all Australian governments is positive. Have you done any sums with the Commonwealth taken out of that equation?

Prof. Davidson—If you take the Commonwealth out, the states are in negative—and that is mostly driven by New South Wales.

CHAIR—I am not an economist by a long stretch of the imagination, but are you still saying that the fact that the states themselves, as opposed to the Commonwealth, are in deficit has no impact on inflationary trends?

Prof. Davidson—Yes. The states are misallocating capital—I have no doubt about that—but that itself is not going to cause inflation. You need to have some expansion in the money supply. Unless that is causing an expansion in the money supply, it is not going to cause inflation. The states overall are in deficit, driven mostly by New South Wales, but the Commonwealth has such massive cash surpluses that it is pulling the entire government state sector into the positive.

CHAIR—You gave some figures on which states were in positive and which were in negative. Where did you find those figures? And are they publicly available?

Prof. Davidson—I found them in the Australian Bureau of Statistics Government Finance Statistics category 5512.0. I have the summary page, which I will hand over to you to photocopy. They are in the ABS statistics, and those are the latest numbers.

CHAIR—Finally, what is the rationale for public utilities—for example, a water utility—for making a profit to pay a dividend to the state government? You are equating it to private companies that have to pay a dividend to their shareholders. Why should a public good enterprise, such as a water authority, be paying an income stream to a state government rather than re-investing it and getting their own stocks in order?

Prof. Davidson—Let us take the water utilities as an example. They are a natural monopoly. We could debate whether we would prefer a natural monopoly to be in private or public hands. In some states they are in public hands. They are being run on a commercial basis, which I think is entirely correct. As any other commercial operation, they earn profits—some of which they can choose to re-invest and some of which they can choose to pay as a dividend, as the case may be.

CHAIR—Could I interrupt you there. If they need to borrow, can they borrow of their own volition or do they have to get the state government to approve that and borrow on their behalf?

Prof. Davidson—My understanding is that all borrowing decisions need to be approved by Treasury. I may be open to correction there, but that is my understanding. Treasury will then approve or disapprove.

CHAIR—And do it at government rate, which you mentioned in your paper.

Prof. Davidson—Yes. The money is borrowed at the AAA rating and then the entity has to make a settle-up payment to the government again.

CHAIR—The entity does not have control over its own destiny. The entity may say, ‘We could use our profits to build more pipelines,’ but the government may say, ‘We would rather get your revenue and spend it on hospitals; therefore, forget about the thing you are in business for.’ I am after an economic rationale, or an IPA rationale, for this.

Prof. Davidson—I understand the point that you are making, but in many respects these are entities with a controlling shareholder. Any entity with an identifiable controlling shareholder would have to get their controlling shareholder’s permission to make major decisions. It is not unreasonable for a controlling shareholder to tell the company that they would like to have a dividend.

CHAIR—But is there a rationale for that? Is that good policy?

Prof. Davidson—Governments are responsible to their electors on infrastructure and what have you. It is true that money may not have been spent on infrastructure, but the voters are not dissatisfied with that.

CHAIR—I do not want to enter into a debate, but in Queensland there are lots of very profitable port authorities. They are required to pay huge dividends to the government; but, because of that, we have ships sitting off Hay Point and other places, costing Australia and the world economy billions of dollars because the port infrastructure has not been put in. When you say to the port authorities, ‘Why don’t you fix it up?’, they say, ‘We haven’t got the dough; we have to pay up to the state government.’

Prof. Davidson—The state government, as a controlling shareholder, is making an investment call. I do not really know that it is appropriate for us to second-guess their investment calls without having a lot more information about what it is they are doing. I would also say that a lot more private companies should be thinking about building their own ports. One of the reasons they do not do that is because of the ACCC’s access policy. I do not even think it is the access

per se; it is the fact that the ACCC wants to regulate the price at which access is done. I would have thought that a lot of coal exporting mine companies would build ports if they knew that the ACCC was not going to effectively nationalise them. It is the same with broadband. It is the same with a lot of infrastructure. The private sector would build it if it were not for the ACCC. I hear your argument, but the state governments are the effective owners. There is opposition to the state governments, and the opposition in those states should be doing a better job of articulating those arguments.

CHAIR—I am from Queensland.

Prof. Davidson—I am not saying that your arguments are right or wrong; I am simply saying that there is competition to be the controlling shareholder of those assets.

CHAIR—Professor, while we would all love to spend much more time with you, our schedule prevents us from doing so. Thank you very much again for your time this morning, for your submissions and for opening our minds to a number of issues.

[12.40 pm]

FITZGERALD, Dr Vincent William John, Chairman, Allen Consulting Group Pty Ltd

CHAIR—Welcome. We very much appreciate your appearing before us today. We are indeed fortunate in having your thoughts on these issues. Your submission generally is in relation to three papers, two of which you were totally responsible for and one of which you were partly responsible for. Perhaps you are prepared to make an opening statement. We will then ask you some questions.

Dr FitzGerald—Thank you. After listening to the exchange just had with the previous witness, I can think of a couple of other reports that I might have included in the particular selection I have provided. For example, I did an extensive piece of work back in 1998, I think, when the previous government was looking at national tax reform. That piece of work was on the option of the states re-entering what constitutionally they are empowered to do, which is raising a share of the income tax. My work addressed how that would work constitutionally, practically and so on. In fact, I have done further work on that more recently. I have also been a regular commentator on the state budget, particularly here in Victoria, and I could talk more generally about things like debt funding of infrastructure and so on.

Of the three reports that I have provided, one is what Ross Garnaut and I did on Commonwealth-state funding. That was partly looking at the way horizontal fiscal equalisation works—in other words, how the GST proceeds are distributed among the states. However, a less focused upon part of the report concerned the relationships between the Commonwealth and the states around those areas where the Commonwealth has specific purpose payments. More recently, in a series of reports that the Victorian government has put into the COAG process, we in my firm enlarged upon that set of issues, dealing with how the Commonwealth and the states mesh in funding bread-and-butter areas like health, education, transport and the like, with both governments working together—and that was a more general treatment. The more recent one focused on the mechanism of specific purpose payments in that area. But, as I have said, I am happy to discuss almost any aspect of Commonwealth-state relations or state finances, as long as I am not expected to quote figures in fine detail.

Senator FORSHAW—Thank you for your submission and the copy of the papers. I am seeking a comment from you regarding evidence that was given this morning by the shadow Treasurer, which you were not present for, and you probably have not seen the written submission that was provided to us with some additional tables and graphs this morning. I am interested in that Mr Wells—I hope that I am quoting him reasonably accurately—said that the state government has been raising huge revenues or has had huge increases in revenue since it took office. I think he said that it is ‘swimming in money’. It has not spent it on improving services, upgrading infrastructure or buying new infrastructure. One would ask: where has the money gone? He also asserted that the state government is increasing debt and that debt is heading towards—I think the figure was—\$24 billion.

CHAIR—Yes.

Senator FORSHAW—Perhaps you could comment on that assertion. It might be more appropriate if you were to get a copy of the government's three- or four-page submission and papers and send us a further comment. That is a political argument, but it is put as a factual analysis. What is your response?

Dr FitzGerald—In my opinion, the state of Victoria, under the immediate previous Kennett government and the current government, has been pretty well run financially, particularly in comparison with your own state, Senator Forshaw.

Senator FORSHAW—I am not here to defend New South Wales. You would have found it interesting at the conference a couple of weeks ago.

Dr FitzGerald—While budgetary circumstances have been quite benign for a state such as Victoria compared with circumstances, if we go back, during the period after the previous Labor government, when the state's finances were in terrible shape, things have improved considerably. Partly, if you are talking about the last half decade, that is to do with the economic boom that the whole country has been experiencing. However, far and away, the great bulk of the proceeds in tax receipts from that have gone to the Commonwealth and not to the states. Certainly, the GST proceeds in aggregate have gone up more or less in line with economic activity although not quite to the extent that, say, corporate tax has, which is loaded towards how well Rio, BHP and the like do. Nevertheless, the GST proceeds have grown quite well.

Victoria is experiencing stresses and strains that are in a second tier not far behind the resource states, because Victoria has been a locus of population growth and of preferred settlement for immigrants; we have had a strong share of those. Therefore, this state—even though it is not experiencing the same backlog of pressures on its infrastructure as experienced by south-east Queensland, for example—is experiencing stresses and strains.

It seems to me that it is true that this state, like Queensland, is playing catch-up with getting infrastructure on the ground to provide transport services and the like to both the economy and the community, but the latest budget does a couple of things that I think are very sensible. First, it lifts the rate of infrastructure spending to about \$4 billion or so a year, lifting the proportion of that that is funded from its own recurrent surpluses to a new rule of a minimum of one per cent of their revenues, which are about \$40 billion. In addition, it plans, over the next few years, to devote about \$800 million a year to the running of surpluses, which, along with accumulated depreciation provisions and new net borrowing, are funding quite a stepped up infrastructure program.

Queensland is doing the same. Perhaps I might say, Senator Macdonald, that the south-east Queensland regional plan is a model of what you ought to do when you realise that you have a problem and you have to plan coherently for it. We have had Sir Rod Eddington do a more limited exercise, but at least here in Victoria there is also an overall plan for a major part of the problem.

In my opinion, if you look at the state's debt position—and I happened to bring a chart from the state Treasurer's budget presentation—the debt levels that we are running at now are very, very low compared to the levels of debt for both general government and the non-financial public sector in general that were common in earlier days when there was a much bigger scale of

investment in roads and so on. Eight per cent of gross state product as a level of non-financial public sector net debt is quite low. In the private sector that would be regarded as a very lazy balance sheet. The general government sector only has about three per cent of gross state product in net debt. In my opinion, while the state of Victoria is borrowing to supplement its own surpluses and its accumulated depreciation provisions to fund infrastructure, its use of debt is very, very prudent and not at all out of the norm.

Senator FORSHAW—If you would not mind, I think it might be useful if we gave you a copy of the documents the shadow Treasurer tabled this morning and his submission. If you then want to add anything further in writing, do.

CHAIR—I just want to clarify something. Dr FitzGerald, your graph is quite different to the one which was supplied to us by the shadow Treasurer, but he is also quoting Victorian state budget papers—his graph takes it out to 2012, of course.

Dr FitzGerald—So does mine. What he seems to have done is to slice the bit before 1992 and blow the scale up—whereas mine goes back to 1962.

CHAIR—I see: he is starting from 1992.

Dr FitzGerald—Yes, and mine goes to 1962.

CHAIR—Without studying it, his graph looks about right, doesn't it?

Dr FitzGerald—Yes.

CHAIR—It shows that there is a forecast for very substantial borrowings—more substantial than they have been in the period, say, from 1998 to the current time. There are projected to be very substantial borrowings in the next three of the out years.

Senator FORSHAW—We are not talking about borrowing; we are talking about net debt, which actually suits your argument.

Dr FitzGerald—I am not sure that distinction is important for the point here. My view would be that, in the period in the middle of the shadow Treasurer's graph, we were underinvesting in infrastructure and we are paying for that now. We have rising congestion on our roads; we have increasing congestion in even the public transport system; we have a backlog of facilities, and not simply current services, in health; and so on. The test of whether debt is excessive is not whether the graph has gone up—the graph should have gone up. The test is whether the debt can be serviced within an overall budget framework which keeps taxes reasonable and is sustainable. As with the previous government, the present Victorian government has had a strong focus on the competitiveness of the state's tax framework vis-a-vis your own state, Senator Forshaw, and the Australian average, as well as the large state to our north. The array of taxes in Victoria is now pretty much in the same ballpark as Queensland; it is not a high-taxing state. The debt can be funded without high taxes.

CHAIR—I think Mr Wells's point was—and he agreed with a lot of the things you are saying—that there has been a very substantial increase in revenue over the last seven years from

the GST and other things. But, at the same time, that has not been spent on the infrastructure that has been needed or on services, according to Mr Wells's submission. His question was: so where has it gone? With the increase in revenue, is that sort of increase in debt needed to do the infrastructure things that are required?

Dr FitzGerald—In my opinion, we are playing catch-up, as is the nation generally. We have got stresses and strains in export infrastructure. You mentioned Hay Point and I think it is worse nearby at Dalrymple Bay, which has been held up by awful regulatory snafus. Bulk export infrastructure is the most obvious area that we see occasionally highlighted in the media, but it is also right in the metropolitan regions of Australia, whether you are talking about Brisbane, Sydney, Melbourne, Perth, Adelaide or perhaps Hobart—certainly in the bigger cities. In today's service economy era, when the transport of goods and people around those regions is what makes the economy go, we clearly have backlogs. Having strong infrastructure investment programs is overdue, frankly. Mr Wells is right to that extent.

Where does the money go? I do not want to defend the state budget, but they have increased spending on health and education. Those two areas of bread-and-butter services are obviously very labour intensive. They have just increased salaries for teachers rather than see them all go to New South Wales or Western Australia, or at least some at the margin.

CHAIR—I understand it is not in the budget though.

Dr FitzGerald—It is, actually. It is buried in the contingency, which, if you are a student of the budget papers, you can find in one table buried in a thick volume that no-one ever reads. It is in there.

CHAIR—Well apparently the Treasurer did not know where it was mentioned when he was asked at estimates. I will get a message to the Treasurer so he can find it!

Dr FitzGerald—It is in the budget contingency. I get into the budget lockup each year as a commentator on the budget and I had one of the Treasury people point out to me where to find it.

Senator FORSHAW—You didn't need to admit that!

Dr FitzGerald—Where has the money gone? The money has partly gone into surpluses, which have funded infrastructure. The expenditure on infrastructure in this state, as in every state, has exceeded the surpluses on recurrent budget that have been generated. Of the roughly \$4 billion a year that Victoria is planning to spend over the next few years, only about 20 per cent is coming from budget surpluses. That is where the surplus is going. Yes, there is another slice of 25 per cent or 30 per cent that is coming from increased borrowing. But, with the state's population and economy growing, that is not unreasonable. The graph is rising but it is still down at very prudent levels. General government net debt of three per cent of gross state product is very prudent and even when they throw in the enterprises it is only seven or eight per cent.

Senator BUSHBY—You have actually asked the main question I was going to ask, but I might follow on with it a little bit. I am still interested in the fact that the overall size of the budget has essentially doubled in the last 10 years in terms of revenue and in where that money is currently being spent.

Dr FitzGerald—The state government?

Senator BUSHBY—Yes, the state government. I know you talked about that in reasonable detail there. What concerns me is the state government's ability to continue to deliver the services that they currently provide. We have received evidence today that suggests they are not providing the services that they should be. Be that as it may, they appear on the evidence that has come before me to have committed, in an ongoing sense, a large part of their \$37 billion budget to recurrent funding. If the economy turns, whether as a result of what is going on in the US or otherwise, and their ability to raise revenue falls, how exposed do you think the budget is in terms of the government's ability to continue to deliver the current level of services and infrastructure?

Dr FitzGerald—Like all of the state governments, Victoria makes a clear distinction between its recurrent budget and its capital budget, whereas the Commonwealth has tended to confuse those a little in its presentation. The fact that Victoria is budgeting on a reasonably conservative basis, as I judge it, for about \$800 million a year of surpluses on its recurrent budget suggests to me that there is a reasonable buffer against the possibility of a somewhat less buoyant economic outlook than we now think is reasonable to expect. I do not know that anyone has a serious view that there is the possibility of a really major economic downturn, which would completely change the picture for both the Commonwealth and the states. In my opinion, it is reasonable to plan for at least moderate growth, and the Commonwealth is only projecting quite moderate growth, given the fact that Chinese and now Indian growth, which are underpinning the strong performance of our export industries, do not look likely to stop suddenly. They may have periods when they have to be reined in a bit or some other factor slows them down, but it seems to be that for the next few years at least the sources of economic growth and strong government revenues in Australia are reasonably assured—reasonably. This state's budget has buffers in it that would allow it to pretty much do what it needs to do, even if we slowed to a couple of per cent instead of three per cent growth. In fact, the Victorian budget papers present a sensitivity analysis of that sort, and it shows that they could withstand a considerably slower growth outlook. They would presumably have to raise their debt a little higher to maintain the infrastructure program, but, in my opinion, their infrastructure investment levels are ones that I would maintain, even at the expense of having the debt go somewhat higher.

Senator BUSHBY—Are you concerned, when looking at that level of debt, that we are talking of going up to \$24 billion by 2012. Do you think that is getting into an area where it is still within—

Dr FitzGerald—It is still within reason, yes.

Senator BUSHBY—I cannot recall the exact details, but I understand that the New South Wales government, when Bob Carr was first elected, implemented an act essentially requiring them to put money away in good times so that they could ensure that they continued to deliver services in the bad times. My understanding is also—we have not been to New South Wales to gather evidence—that they have basically ignored that act. Do you think it is a generally prudent approach that when a government does have the ability to generate surpluses it should make provisions to ensure that it can continue to deliver services and infrastructure projects when its capacity to raise revenue is not as good?

Dr FitzGerald—Most of the states have not really been in a position to run up large financial assets. Queensland is the one state that has historically had positive financial assets, and even it is having to invest heavily in infrastructure at the moment. Therefore, in effect, it is drawing on the fat that it built up. I certainly think that every state government must at least recover, through its revenues, the cost of its recurrent expenditure. In times when—if you can imagine such circumstances—the needs for infrastructure spending are well met and the revenues are strong, I would certainly consider building up financial assets, as Queensland has done in the past and as the Commonwealth is doing through the Future Fund, even though it is boringly related to meeting a particular liability on future Commonwealth budgets—that for superannuation of civil servants. I suppose it is a politically more presentable method to put some in a higher education fund—and now there are ones for health and other things. Those funds seem to me to be things that can be presented to the public as evidence of doing what you are saying: building up the resources to spend in those areas when perhaps it is not possible to run recurrent surpluses on the scale we are now. In a small way, I think, some of the states have the capacity to do that. But for most of them it is not so much a matter of building up financial assets; it is how much debt they can service.

Senator BUSHBY—I have one final question which is sort of an aside—but not really, because it may have some potential impact. Given your association with Ross Garnaut in one of these reports, do you think that the impact of measures that are likely to be required for climate change mitigation will have any effect on the economic circumstances of the nation and the ability of state and federal governments to raise revenue?

Dr FitzGerald—My association with Ross Garnaut was not in the matter of addressing climate change.

Senator BUSHBY—Yes, that is why I said my question was an aside.

Dr FitzGerald—Whatever mechanism is the ultimate outcome of the Garnaut inquiry and the governmental response to it—which will not necessarily implement what he suggests, anyway—it will either be an emissions trading system, a carbon tax system or some hybrid system that, whatever way you cut it, puts up the price of carbon. That means that it will impact on utilities that the states have a very strong interest in, whether they be electricity or gas. To the extent that that impact cannot easily be passed onto consumers or industry, it may affect government budgets. But I think the issues will be relatively even in their impact across Australia. I imagine that ultimately all of us who use energy will pay and the state governments will manage to recalibrate their budgets to still be able to do what they do. Certainly it will be a big adjustment process for both levels of government.

If I could answer a question that I was not asked but which you asked the professor who appeared before me: the states are constitutionally empowered right now to raise income tax—the reasons that they do not are numerous. One of them was that the Commonwealth blocked re-entry of the states into income tax after World War II and as late as 1970 using its grants power. In other words it said, ‘If you raise income tax we’ll take grants away from you.’ Also, raising income tax was a politically difficult thing to do as long as the Commonwealth would not make room. In the Fraser period, when I was in Canberra, the chalice offered to the states was an offer to add income tax. It will not easily work that way. The Commonwealth has to say, ‘We’ll reduce

the part of the income tax that we keep and allow you to have a share, and we'll take some grants away from you in exchange,' which in my opinion would be a good thing.

CHAIR—That was Professor Davidson's proposal—that the Commonwealth should get out of individual taxation and leave that to the states.

Dr FitzGerald—I would not suggest that. In fact, when I was working for the government of Queensland back in 1998, there were two proposals which were very straightforward. Constitutionally they had been checked in the Fraser period—that is, it is constitutional for the states to raise an amount of income tax which is referred in its definition in state legislation to the Commonwealth income tax. For example, you could say, 'If you are a resident of Queensland and identify yourself as such on your tax return, 10 per cent of your taxes as defined by the Commonwealth income tax law will come to your state.' That is perfectly constitutional. It can be done either by having the first 10 per cent of people's assessable income after the tax-free threshold going to the states so that there is no redistribution in what goes to the states or, as federal officials preferred when this was debated between the Commonwealth and the states, just have a simple share of the income tax. In other words, take the progressive income tax and start off with the Commonwealth retreating 10 per cent so the states get 10 per cent of the total take. The states get exactly the same amount. No-one notices anything different on their tax return. The ATO collects it. After that the states are free to either lower or raise their 10 per cent to nine or 11 or whatever they want to do. That is constitutionally more secure from the states' point of view than the GST, which is a federal tax and can be changed by a vote in the Senate regardless of how entrenched it looks.

CHAIR—Not only by a vote in the Senate.

Dr FitzGerald—It is political.

CHAIR—All the states and the Commonwealth have to agree.

Dr FitzGerald—That is what the law says, but you can change that law by a vote in the Senate.

CHAIR—I see.

Senator BUSHBY—And in the lower house.

Senator FORSHAW—Can I just follow that up. Does your analysis still hold following the High Court decision on the industrial relations laws? In other words, could the corporations power be used to prevent a state from imposing income tax?

Dr FitzGerald—I do not suggest that the states get into corporate income tax. That would be—

Senator FORSHAW—Sorry, my point was: can it be argued that a federal government could constitutionally prevent a state from imposing income tax on individuals on the basis of the corporations power?

Dr FitzGerald—I do not believe so.

Senator FORSHAW—Why not? If they can regulate every aspect of the employment relationship between an employee and—

Dr FitzGerald—But it is not part of an employment relationship.

Senator FORSHAW—The payment of wages?

Dr FitzGerald—I think that would be drawing a very long bow and I am not a lawyer.

Senator FORSHAW—Okay, I do not know the answer either, but a lot of people have argued that the corporations power, which was regarded as regulating financial and trading corporations, has now been extended to essentially cover every aspect of what a corporation does, including its industrial relations with its employees—what it can pay them and the conditions under which they can be employed. It seems to me that it is not much to say that the Commonwealth government can use that power together with its other powers to say that it has the power to impose income tax.

Senator CHAPMAN—On corporations?

Senator FORSHAW—No, on the employees of corporations. I am just putting it as a point.

Dr FitzGerald—I am not a lawyer, but on this issue I do not believe that follows.

Senator FORSHAW—I am not trying to disagree. I am just saying it raises that issue.

Dr FitzGerald—Sure. The fact is though that the states having a small slice of the income tax take, instead of having a lot of grants which come with micromanagement and duplication, is believed by experts to be constitutional. Gavan Griffith QC, the former Solicitor-General, studied this in great detail and advised that there were various ways that were constitutionally sound—and there is no doubt that states can raise income tax—of having an income tax that is referred to the Commonwealth tax. That was the point that he looked at. In my opinion, the states having a more secure revenue base, which would take political agreement to get to at the start, and being less dependent on grants but still dependent enough to look after the needs of small states like Tasmania would be a better system.

Senator CHAPMAN—Following on from what you have said, Dr FitzGerald, given what you have indicated in here as support for the principle of subsidiarity—and also I think at some stage you indicate that there could or should be a stronger role for the states in the provision of services—and given also that what certainly appears to be one of the problems of our current situation is the overlap, the duplication and the bureaucratic inefficiencies that result from having the Commonwealth and the states both involved in certain areas of services, why not go the whole hog, as you might call it, that Professor Davidson suggests and give all the income tax to the states and let them deal with the service delivery issues?

Dr FitzGerald—You do not need all the income tax to go to the states for them to deal with it all.

Senator CHAPMAN—Well, not all; he was suggesting personal income tax, I think, and corporate income tax would remain with the Commonwealth.

Dr FitzGerald—I think the amount that the Commonwealth is budgeting to give to the states in specific purpose payments is \$33 billion for 2008-09, roughly—and \$45 billion in GST proceeds. But that \$33 billion is far, far less than the proceeds of personal income tax.

Senator CHAPMAN—Yes, but if they were to take over all of health and all of education they would need—

Dr FitzGerald—The Commonwealth funds less than half of hospital health services. The only bits that are not funded by those specific purpose payments and state money are aged care—although the states do spend money on aged care, including substantially so in Victoria. Also, if the states were to do it all, you would have to bring in things like the Pharmaceutical Benefits Scheme, which makes eminent sense to run nationally because of issues of the approval of drugs and bringing together the nation's buying power against the drug companies. Those are things which are best handled nationally. While you might give, say, state-level authorities greater flexibility in drawing on that scheme, it probably ought to be run nationally. So parts of the health system that are currently administered by the Commonwealth could go to the states, but it is hard to see how they all could. It is the local customisation of services that should be totally integrated and run at the state level. Supporting national systems like the pharmaceutical benefits system—I do not think so.

Senator CHAPMAN—But hospitals could be.

Dr FitzGerald—Hospitals would be more completely run by the states with largely their own money.

Senator CHAPMAN—And schools.

Dr FitzGerald—Yes, and schools—including, by the way, as we propose, bringing the non-government schools that are largely government funded within a single framework. The Catholic system has been talking about a system which is quite common in Europe—for example, having a defined thing called public education which can be delivered in state schools but can be delivered in other schools as long as you meet the criteria, accountability requirements and so on. I would see a great deal of merit in having all school funding administered within a single framework and consistently, which is not the case now.

Senator CHAPMAN—I notice on that that you indicate there needs to be a greater emphasis on need in education.

Dr FitzGerald—It is very controversial.

Senator CHAPMAN—Can I ask whether a voucher system, whereby you can relate the amount of support you give to a student directly to their parents' income, would be a better way of doing that?

Dr FitzGerald—It is probably not an efficient way. There are some schemes like that now. There are programs at state level, certainly in Victoria, providing it—admittedly through the schools—on the basis of the socioeconomic status of the families that use those schools. But it seems to me that some institutional funding that is loaded towards schools in areas where there are, say, large immigrant populations or whatever—a combination of the two is what you need, rather than a pure voucher system. I do not think that you can easily, for example, have a school in an area which has that kind of population in its catchment. It has got to be a good school in the first place, or people will not bring their vouchers to it. So I think a combination of funding to the school and some sort of tailored funding to the parents is all I would consider.

Voucher systems are not terribly necessary to achieve some of the things you want to achieve. If you want a little bit of competition among schools, you can do what Victoria does, and that is to give preference to people who live in a school's area but allow people to go to any school that will accept them. That allows schools to, say, compete by having a good music program or whatever it might be, but at the same time the system is predominantly focused on funding schools and over the last few years has topped up the amount that goes to needy schools.

CHAIR—I am intrigued. You are suggesting that private and public schools, state schools, should get the same basic funding from both the state and federal governments and then, if anyone wants to top that up, they charge the parents over and above that, if they want a Christian education or better sporting fields or something?

Dr FitzGerald—I am saying that those schools that are predominantly dependent on public funding—which means that the largest group other than the state schools is Catholic schools—get very different levels of support from the states. Queensland is considerably more generous than Victoria, for example. There are situations in Queensland where a Catholic school gets more per capita funding from the two levels of government combined than the state school down the road.

CHAIR—Is that right?

Dr FitzGerald—Yes—at least it was.

CHAIR—Capital and recurrent?

Dr FitzGerald—No, I am just talking about recurrent. These are anomalies, but they—

CHAIR—But you are suggesting, really, that all schools—

Dr FitzGerald—I am not talking about independent schools, which are a different issue. The richest independent schools presumably, if you have needs based funding, would get some funding but not as much.

CHAIR—But what I understand you as saying is: from both state and federal sources; wherever.

Dr FitzGerald—Yes, they should be made into one.

CHAIR—And all schools. You are exempting independents, but that is—

Dr FitzGerald—All schools that sign up to provide public education.

CHAIR—To a standard, yes. They would get a certain level whether they are Catholic or state. I cannot understand why not independent, but anyhow.

Dr FitzGerald—They would be there, but it would turn out to be different because of the need criterion; that is all.

CHAIR—But then above that, if you wanted goods, playing fields or particular extra facilities—

Dr FitzGerald—Yes, if you raised more money.

CHAIR—you would charge the parents. But you are saying everyone should get the—

Dr FitzGerald—There should be a consistent standard for public funding. That is what I am saying. It could have a means-testing element in it, but insofar as we have anomalous situations where schools with very similar populations, like Catholic elementary schools and public ones, are getting different levels of funding for doing essentially the same thing, under more or less the same—

CHAIR—That was my experience in Queensland. Catholic schools, particularly in Queensland, were not getting as much from the state government. They were getting a lot more from the federal government, but if you joined them both together they were still getting less than the state schools were getting.

Dr FitzGerald—That is true, and yet there were anomalies where it was the other way around.

CHAIR—I am surprised to hear that.

Dr FitzGerald—Terry Moran told me that, and he was the head of the department up there for a while. That is when he said that there was this small number of anomalies where it was the other way around.

CHAIR—Just very quickly, in one of your papers—and I cannot identify which one—you said that, if you cut back on many tax breaks that have proliferated in the tax system, that would be a better public policy. Can you provide some examples, just generally, of tax breaks you would want to remove at state level?

Dr FitzGerald—The tax breaks I was talking about were basically a series of concessions at the Commonwealth level. This was not about Commonwealth-state relations; it was about the issue of how, from the point of view of being competitive for highly skilled internationally mobile labour, we might get the top rate down without doing too much damage to equity. The point of the paper that I did a few years ago was to look at who enjoys the benefit of tax breaks like income splitting and, for that matter, the concessions on capital gains tax compared to

ordinary income tax and some of the superannuation tax concessions. There are a variety of other ones that are in the annual tax expenditure statement that added up then to about \$30 billion a year.

CHAIR—No, I was interested in state—

Dr FitzGerald—The paper argued in a rough sort of way that, if you got rid of a swag of those tax concessions that were biased towards well-off people and instead gave them a lower rate on a more comprehensive definition of income, you would have a more internationally competitive system of taxing highly skilled individuals.

Senator CHAPMAN—Your report says, and others have said it as well, that by OECD standards Australia is not a highly taxed country.

Dr FitzGerald—That is true.

Senator CHAPMAN—It probably is true, but doesn't that ignore the point that we are not competing with OECD countries; we are competing with Hong Kong and Thailand and Singapore and those countries. We never seem to compare our tax rates with them in these reports.

Dr FitzGerald—That is a good point; we are not competing with Third World countries, either. But in areas like finance, which is an area where there has been an ambition to make sure we remain a competitive financial centre, and given our huge per capita stake in superannuation, we ought to be a competitive place in funds management. I think in the federal budget there has been a move to help that. But one of the things that we suffer from vis-a-vis Singapore—I have a son who is working up there in financial services—or Hong Kong or Shanghai is that we have higher rates of tax on the professionals who work in that sector. It is part of the calculus and hence the—I certainly agree with your point that we should not be comparing with how they are taxed in Berlin, but how they are taxed in those places.

CHAIR—Bangkok.

Dr FitzGerald—Well, not so much Bangkok; that is not a serious competitor.

CHAIR—Singapore perhaps?

Dr FitzGerald—Singapore certainly is, as is Hong Kong and, increasingly, Shanghai.

CHAIR—Dr FitzGerald, thank you very much for your time. Again we have gone over time, and we appreciate your indulgence and your contribution to the committee. Thank you very much for coming along.

[1.28 pm]

WINES, Associate Professor Graeme Leslie, Private capacity

CHAIR—Welcome. Thank you very much for coming along and for your paper, which I found very interesting. If you would like to make an opening statement, we will have some questions for you after that.

Prof. Wines—I am from Deakin University, from the Warrnambool campus—a regional campus. I am an associate professor in accounting, so, while my submission does touch on economics, I am certainly not an economist. My submission was mainly under the area of goods and services tax, public-private partnerships, and budgeting and financial reporting. The first two areas were really just general comments coming from my research in looking at government budgets; it is that third area—budgeting and financial reporting—which is my major area of research interest.

On the goods and services tax, I think there is a lot of rhetoric that the goods and services tax has solved all the states' financing problems. If you look at the Victorian 2007-08 budget—that is, the one released in May last year, not the one just released—28.2 per cent of their revenue comes from GST and 15.7 per cent from Commonwealth general specific purpose payments. So as an example you can see that 44 per cent of Victoria's revenue comes from the Commonwealth. The other 56 per cent is from state taxes, especially payroll tax and property tax. My observation here is that those other forms of state taxes are going to be considerably relied on into the future. Even after that, even with what have been healthy budget surpluses, it needs to be kept in mind that if the economy does have a bit of a downturn then the states' finances could be dented fairly quickly. Incidentally, that would also affect Commonwealth revenues. Most of the commentators are saying that the economy will continue booming, particularly with the terms of trade, coal prices and steel prices seeming to be improving. Nevertheless, I guess you still need to look four, five or six years down the track.

Concerning public-private partnerships, when you look at the states there are considerable capital expenditures required in health, education and transport. Climate change issues, particularly water and energy, will probably continue to put pressures on those. There is no doubt that public-private partnerships will be a major part of the equation. Victoria's desalination plant is an example of that. My major observation there is just to make sure that there are clear transparency, accountability, oversight and risk assessment procedures. Using Victoria's desalination plant as an example, I am no expert on desalination but certainly a few commentators are saying that it is a really costly option, and you have the question of how much overview there is of the states making decisions like that. That is not saying that it may not be the way to go, but it does need considerable transparency.

Concerning budget and financial reporting, we have a new accounting standard for governments, AASB 1049, operative from 1 July 2008. That should lead to further uniformity in reporting. Over past years, the states and Commonwealth have done different things with their accounting, which requires the figures to be carefully looked at to see what is really going on.

CHAIR—Did the most recent Commonwealth budget adopt AASB 1049?

Prof. Wines—Not specifically. That is going to be one of my closing comments. In the past the Commonwealth government has not included the GST revenue in the budget figures and such, unless you go to the statements at the very back. My point is that we have the Charter of Budget Honesty, yet here was the government doing something which was clearly against what the accounting rules said. The ABS rules and the accounting standard rules clearly said the GST was a federal tax so it should go in the revenues, and likewise the payments to the states go out. I was using that as an example. The rules often say, ‘Here are the accounting standards, but you can depart if you note that,’ and that is what the Commonwealth used to do. I note that this year the GST revenue has been included, so that has been a major change. Not a lot of commentators seemed to pick that point up.

CHAIR—What is the difference if you show it as coming in and going out and it is the same amount?

Prof. Wines—The argument as to why the Commonwealth in the past did not put it in was because an election promise way back in 1996 or 1998 was that revenue as a percentage of gross national product would not be increased. If you included the GST revenue, it would have. So it does not make a change to the bottom-line deficit or surplus, but it does make a difference to total revenue. I think that was why the previous government was so reticent to include that. My only point there was that perhaps we need a charter of budget honesty for the states where we do not allow this departure from the rules if it is disclosed. Public companies cannot do that. They have to follow the standards.

The other thing is that it does negate the effect of some things that governments have done in the past. For example, a few years ago the Tasmanian government were saying, ‘We’ve got a surplus,’ but that was only when they took their original budget deficit figure and added back. They said, ‘We’ve got some special purpose payments in there so we’ll add them back and so really we’ve got a surplus.’ I think something like a charter of budget honesty would help make sure that they follow the rules everywhere, including in unaudited statements like the budget.

CHAIR—Thank you very much, Professor Wines. And thank you for your submission, which I thought was quite comprehensive and put together in a way that even I could understand. So thank you for that.

Senator BUSHBY—Professor Wines, most of what you say in your submission is fairly self-explanatory. I want to ask about your comment on the GST solving the fiscal problems of states. I hear what you are saying in terms of it being a major component but not the major component of a lot of state budgets. In my state it is the major, single contributor to the budget. It is slightly different for some of the bigger states.

Senator CHAPMAN—It is here as well. It is the major, single contributor.

Senator BUSHBY—Yes. But I think it makes up more than half of the budget in Tasmania. Despite the fact that other key components have also contributed to solving the fiscal challenges of state governments, the provision of the GST, as it currently stands, certainly does provide them with certainty that they did not have before. The Commonwealth Grants Commission used

to be a two-part process. I might be wrong about this, but my understanding is that the first part of it was arguing about how much, and the second part was about dividing it up. The 'how much' part of it has now been solved. It is a self-fulfilling thing: it turns up and then you basically have to decide how it is divided up.

Prof. Wines—My having said that was not saying that the GST had not been a good development.

Senator BUSHBY—Yes. I am just trying to tease that out a little. Has the role of the GST in solving the states' fiscal problems been overstated? I think it has provided certainty in terms of addressing those problems, and it is a growth tax. Would you say that it has been a considerable assistance in addressing fiscal challenges because it is a growth tax, it is certain and the states know that it is always going to be there?

Prof. Wines—I agree entirely with that. That is not saying that any changes should be made to the GST arrangements. The GST was introduced in 2000-01—a period when the economy was booming, and it has been booming ever since. If consumer spending is hit a little bit with interest rates and things like that, it may be that the rate of growth will not continue.

Senator BUSHBY—And it could even get smaller if the economy contracts sufficiently.

Prof. Wines—It could.

Senator BUSHBY—Similarly, any other form of taxation which the federal government may have been raising and then giving back to the states would probably have done as well at the same time?

Prof. Wines—Yes.

Senator BUSHBY—I do not have any more questions at this point.

CHAIR—Just on that same point, Professor Wines, you said in your paper that the Victorian figure for the GST is less than 30 per cent of total revenue and that, joined together, Commonwealth taxes are worth 44 per cent.

Prof. Wines—Yes.

CHAIR—What was it before the GST? I am not asking for figures but whether it was less or more.

Prof. Wines—I could not comment on that. I have not gone back to see. Because the economy has been booming, the GST has helped the surplus position of the states, and that has flowed through automatically rather than having to go through the negotiations with the federal government. You certainly would have expected that, as the economy had been going so well, receipts would have been very healthy. Presumably, in the previous situation, sales tax would have boomed too, on a much narrower base, so you would still have had greater Commonwealth revenue and, therefore, the states would have been in there to try and get a greater share of it.

Senator FORSHAW—Thank you, Professor, for your submission; I found it very concise and informative. I noticed you were sitting in the audience during the evidence of our previous witness, Dr FitzGerald. You refer to the projections for fiscal difficulties coming down the track for both the Commonwealth and the states, but particularly for the states.

Prof. Wines—If there is a major downturn.

Senator FORSHAW—Okay. I know you made that comment, but I note that you said on page 3 of your submission that ‘fiscal positions may be about to change’. You pointed to the forecast in the 2007 budget and forecasts for state budget balances ‘reflecting higher expenditures and slower revenue growth’. We are all aware of the increasing demands on state governments for infrastructure, both replacement and new projects. It seems to me something that is often missed is that a lot of the infrastructure is 50 or 60 years old—it is from the post-war era—and so it has reached its use-by date. Can you comment on whether you have any concerns about what is happening or what is likely to happen with state government debt and borrowings? I guess there has been some discussion on it this morning, and certainly Dr FitzGerald commented on it. He did not see that it was a worrying situation at this stage, but it is always something that commentators and the public will focus on and that state governments focus on: going into deficit and levels of debt.

Prof. Wines—I have a couple of comments. Probably even since I wrote that submission, I think there is less pessimism that perhaps there might be a slowdown in the nearer term, given that the terms of trade have gone so well. So this is probably a pessimistic view, but it could be what would happen down the track. You are quite right with the infrastructure. Now that some of it is 60 years old there is a major need for new infrastructure. This is where the Commonwealth funds in Building Australia fit in as well. It is a matter of where they might get spent and whether the states pick up some of that. If the governments do have to take up some extra borrowing, that is going to hit their operating budget position: they will have some higher interest, so those surpluses will contract. But I think that because the economy has been so healthy for so long and because governments have been able to cut their level of debt—the Commonwealth government has really cut its level of debt and is now in a position where, with those surpluses, it can sit it in with these funds for future spending—there is not a problem that the states are going to suddenly go on some sort of a spending binge and that their borrowings are going to go through the roof. I think they are still in a very healthy position, but those governments have difficult decisions to make in keeping their infrastructure spending up to modernise facilities that perhaps have not been for quite a period of time.

Senator FORSHAW—In the light of that comment, I am almost tempted to ask you, given that I am from New South Wales, to comment on the debate about how you fund future electricity generation, but I will not do that specifically.

CHAIR—Take it as my question then!

Senator FORSHAW—I think the government has made its decision, but it raises something that you have raised—that is, increasing possibilities of governments moving to more PPPs. This could be a long debate, and we do not have the time, but would you like to comment on that? The argument is that a state government cannot possibly afford to borrow \$15 billion or \$20 billion to build new generators.

Prof. Wines—That is right. The issue is: to what extent will general taxpayers be better off if some of these things are privatised? It seems to me there are a couple of opposing forces. One is that private sector operators may well be more efficient in delivery and may have much better capital spending compared to the government. The problem is that management companies and the like tend to look for profits and management fees. So, on the one hand, they might be efficient at the spending level; on the other, you also have extra management fees and profits which those private operators might take. If you are in the position where the government just cannot afford that expenditure, then I think you have to say, ‘There is a place for public-private partnerships, but we want to make sure that, given the risk-return trade-off facing those operators, they are only getting a reasonable level of return for the risk they are undertaking.’

Senator FORSHAW—My final question has to do with another concern that seems to be emerging: how do you ensure that the private sector will invest in the future—given, for instance, the pressures of climate change and the uncertainty of whether or not such an investment in years to come will be worth while if the value of it is likely to decrease or not increase?

Prof. Wines—There have been some major write-downs on tunnels et cetera by private operators, which show that some of their revenues have not been as high as they would have liked them to be.

Senator FORSHAW—The problem there is that it comes back to the state government and they ultimately end up having to do it.

Prof. Wines—Yes, it is a fine line. If you want the governments to be doing it then you have to understand that one way or another it is going to be through taxes, whereas if it is a private operator it is through the fees that they pay for their water or their electricity, for example. I think you just have to make some assessments: how efficient do we think the private operators will be compared to the government running these projects? Given their financial position, can the government afford to do it? Do we go more along the lines of the American system, where you have many more private operators? I do not think I have answered your question.

Senator FORSHAW—I am not sure if there is an answer. At the heart of this debate is the question: even if you sell off government owned assets, how do you ensure that in 15 or 20 years time the private sector will continue to invest?

Prof. Wines—You cannot. If they are not making profits then they may walk away from it.

Senator FORSHAW—So the government buys it back off them?

Prof. Wines—Yes, exactly. So you finish up with the costs anyway. The other point with some of these public-private partnerships is that you need to be careful that they are not counter-productive. I will use the example of when CityLink was put in in Melbourne. To make sure that there was a revenue stream and that cars would use the tunnel, some of the other roads around were actually narrowed. That was sort of letting the private operators get profits, and now, in a way, it has been counter-productive for the transport area.

Senator FORSHAW—If I could just make a final point: it seems to me that the PPPs that work better are those that continue to have some sort of guaranteed government income stream—for instance, those in education and defence. Even though they are run as PPPs or are new facilities being constructed as PPPs, at the end of the day the government is still providing a lot of the income to the private operator to run those defence facilities, schools or hospitals—as distinct from the motorist having to pay for them through the use of a tollway or a tunnel.

Prof. Wines—It also must be remembered that most of these public-private partnerships are what are called BOOT schemes—build, own, operate, transfer. So the government in fact finishes up transferring back down the track. So if CityLink runs for 30 years or whatever, you are looking at whether it has been worthwhile getting the private sector to build that in the first place given what charges the motorists are paying.

Senator FORSHAW—Thank you.

CHAIR—Professor, you say that the Commonwealth should oversee public-private partnerships. Do we not trust the states?

Prof. Wines—That is a difficult one. That is an issue about whether you leave the states absolutely to themselves and say, ‘We have given them the GST revenue and they can do whatever they like with it.’ The Victorian desalination plant might be a good example. I am not sure there has really been enough scrutiny of that, given what commentators have said as to whether in fact it is really a reasonable public-private partnership and that the general consumer will end up paying more for water because of it. Because it is a national issue, all states are affected by the water issue. How much oversight should the Commonwealth do? It seems to be something that is difficult to do in a formal sense. But if the Commonwealth does not oversight it and say, for example, ‘New South Wales is doing something and Victoria is doing something but they are totally different,’ who is going to oversee it to see whether or not they are really worth while.

CHAIR—I am not sure that I have seen that suggested before. There would have to be a lot of rules around that. What power does the Commonwealth have?

Prof. Wines—I am not saying there has to be some formal regulatory authority to oversee that. Again, it is a question of what powers the Commonwealth has, but who else is going to look at it?

CHAIR—Perhaps state oppositions should be doing the accountability bit.

Senator FORSHAW—Could you do it through COAG or something?

Prof. Wines—Maybe, but what do you do with COAG? The states have got their GST revenue anyway. I guess you can fiddle around with the general and specific purpose schemes. That was a bit of an aside to the point about being careful that public-private partnerships are used in appropriate situations.

Senator CHAPMAN—To me the most significant part of your submission relates to government budgets and financial reporting. We heard earlier from the state shadow Treasurer of

the difficulty the opposition has in actually assessing the true state of the budget in Victoria because of the possible camouflaging of recurrent expenditure as capital expenditure. Is that something that you have looked at and is there a way of unravelling that to find the true picture?

Prof. Wines—I have looked at the figures and I cannot tell. If the government gives a summary of something that it is saying is recurrent expenditure in such an area, you just do not know. In fact, you can have accounting standards which say, ‘This sort of thing should be shown as an expense and this is a capital expenditure item,’ but if the government puts out the figures, you are stuck with them. You can look closely at the detail in the budgets and it is still not going to help you see whether a normal recurrent expense item includes something that should be capital expenditure.

Senator CHAPMAN—Or vice versa.

Prof. Wines—Or vice versa; exactly.

Senator CHAPMAN—That is, I think, more the issue. Both here and in South Australia there was argument made to us that items of maintenance, for instance, which should be recurrent expenditure, were in fact being hidden and described as capital.

Prof. Wines—The budgets are not generally audited, so really there is not much of a test on that. When they do the final financial statements they generally are audited, so the only thing you can do is to hope that the Auditor-General picks up those things. But again, even for the auditors going in, it can be difficult to discover.

Senator CHAPMAN—What changes do you think need to be made to the accounting principles of government generally, and state governments in particular, to ensure that greater degree of transparency and accountability?

Prof. Wines—The accounting principles are there that say, ‘This is how things should be done.’ You have only got the Auditor to check that. There is nothing else you can do apart from making sure—and this is where a charter of budget honesty may help—that they follow the spirit of the rules. That is one of the problems with accounting: it is substance rather than form, and there is an area of judgement at the borderline as to whether something is maintenance or truly a capital expenditure improvement. The accounting rules, whilst there is professional judgement, are clear as to how they should be presented. But if the government does not follow that then, if you read the budget statements, you cannot tell whether the government is showing some maintenance expenditure as a capital item and, unless the Auditor-General picks it up in an audit, you are relying on the Treasury, really, to make sure that they do adopt truthful reporting.

Senator CHAPMAN—It seems that they are a law unto themselves in that sense. There is no sanction unless—

Prof. Wines—No, there is no sanction. With companies, if they do not follow an accounting standard and it comes out, the directors can be liable et cetera. That is not the case with governments.

Senator CHAPMAN—Should the Corporations Law apply to governments?

Prof. Wines—Probably not.

Senator FORSHAW—Why isn't it picked up in estimates or public accounts committee hearings in state parliament?

Prof. Wines—That may well be one of the mechanisms that might actually point to what is going wrong, but generally that is after the fact. It is not making sure beforehand. But, yes, the public estimates and those sorts of committees would have a responsibility to look at those sorts of things and have probably picked things up in the past. So, in fact, they are a little bit like the audit function as well.

CHAIR—Thank you, Professor. Finally, do you know if any of the states have adopted that AASB 1049?

Prof. Wines—Not specifically. That is one of the problems. We have basically got two systems at the moment. We have the Government Finance Statistics framework, which is administered by the Australian Bureau of Statistics, and we have the accounting rules which come out of the professional accounting bodies with the Australian Accounting Standards Board. Those rules, in many cases, are exactly the same. So, when you say, 'Have they specifically adopted that?' in most cases adopting the past rules will also result in complying with AASB 1049 when it becomes operative. But there is still that scope now, and you would have to look carefully at budget figures as to what treatment they are using. That was an example—the Commonwealth government, despite both sets of rules saying, 'You should show GST revenue as part of your total revenue,' in fact was not doing that.

CHAIR—I think your submission says that, if you have the same arrangement in every government in Australia, you can make realistic comparisons, but you cannot if you have different standards. You make a good argument in what you have told us. That is probably something we could look at as a recommendation, I think, down the track.

Prof. Wines—I think that also fits in with my other observation—that in a lot of cases, such as in budgets, departures from the rules are allowed. So it is also a matter of making sure that they do actually follow the rules in all respects.

CHAIR—I do not want to overemphasise this point, but you say that, for political rather than economic or accounting reasons, they were not followed in the past—and I am not sure that I would agree with that.

Prof. Wines—And there is another confusion too. For example, just take the measure of the budget surplus. There are at least three different measures that you can use to arrive at the surplus. Is it the accrual based net operating balance, the accrual based fiscal balance or the cash based measure, which the Commonwealth, for example, uses?

CHAIR—We have gone away from accrual based now, haven't we?

Prof. Wines—That is the thing. With all the rules, the rhetoric is that governments have followed accrual accounting—and they do, but you still have to have cash accounting as well to show your cash flow statement. So it is a matter of whether you pick your surplus figure up from

the accrual based statement or from the cash flow statement. All the figures are there. It is just that the Commonwealth picks out the cash based surplus, whereas now most of the states use the net operating balance, which is an accrual based measure. For example, a few years ago, New South Wales was using the fiscal balance as its measure and it was basically heading towards deficit. It suddenly changed from a fiscal balance to a net operating balance so that its surplus would be shown in a better light.

CHAIR—The recent Victorian budget spoke of a surplus of, I think, \$382 million.

Prof. Wines—\$800 million.

CHAIR—\$830 million?

Prof. Wines—Yes.

CHAIR—I wrote those figures down somewhere; I just cannot put my hand on them.

Senator FORSHAW—It was \$828 million, I think.

Prof. Wines—That figure for the Victorian government—

CHAIR—Didn't it go up this year? I thought it was \$880 million.

Senator FORSHAW—I thought he said \$828 for 2008-09.

CHAIR—Okay. The Commonwealth has a budget surplus of 22-point-something billion dollars. Is that apples with apples?

Prof. Wines—No. The state's is a net operating balance, an accrual one, which is operating revenues less operating expenses. The Commonwealth surplus is actually a cash based one, which is revenues less expenses less capital expenditure. So, because it is a cash based figure, it is bringing capital expenditure into—

CHAIR—Is that the difference?

Prof. Wines—Yes.

CHAIR—Accrual does not have capital expenditure in it.

Prof. Wines—The figure that the Victorian government reports is the net operating balance and it does not include capital expenditure, but then you take off capital expenditure and you come up with the fiscal balance.

CHAIR—Have you done the sums? What would the Victorian budget outcome be, if it were done in the same way as the Commonwealth does it?

Prof. Wines—To tell you the truth, I would have to go to the figures to look at that.

CHAIR—It would be considerably less, would it?

Prof. Wines—Let us take the position where they have said that they are going to increase their borrowing for infrastructure purposes. What could well happen is that you have a nice healthy budget surplus on the net operating balance, which they report, but you could fall into deficit in the fiscal balance. That is what happened with New South Wales. When they were reporting the fiscal balance and had a lot of extra capital expenditure coming up, which fell further into the deficit, they suddenly went back to the net operating balance method to announce their budget surplus.

CHAIR—So, in Victoria, without doing the figures, the \$882 million would be considerably less—

Prof. Wines—Under the fiscal method, yes.

CHAIR—if they used the same approach as the Commonwealth.

Prof. Wines—Yes, if they used the cash based measure of the Commonwealth.

CHAIR—And vice versa, I suppose: the Commonwealth's would be substantially higher if it—

Prof. Wines—The Commonwealth tends to be much closer together in the different figures, whereas in the states major capital expenditure can considerably result in differences between the accrual net operating balance and the cash service figure.

Senator FORSHAW—What do we take from all of that? We know that politics are involved in this, but does one set of figures tell you that it is really bad and the other set that they are trying to hide that, or do they just represent different—

Prof. Wines—No, all the figures show different things. How the figures might be different depends on what is happening, for example, with the capital expenditure. To understand those finances and to get a full picture, you need to look at all those figures—look at the accrual ones and see what they are telling you; see what the cash base is telling you—and take them all into account. What has been the problem in the past with some budgets is where they cherry-pick which figure they want to push.

Senator FORSHAW—But it can be—this has happened under all governments—that, say, at the federal level you get what some might describe as not a good result, but then it might be pointed out, for instance, that there is \$X billion in there for this period for a huge defence expenditure or purchase that would appear smaller if you read it out over the next 30 years. Is that a relevant consideration in terms of what the states are doing as well—

Prof. Wines—Yes.

Senator FORSHAW—where, by not including capital expenditure, it may reflect a particular massive infrastructure program over a couple of years that has not occurred before?

Prof. Wines—The \$800 million or so surplus is only the recurrent revenue less expenses. It does not show the capital infrastructure spending. So you need to go to the figures. That is not therefore saying that, if you have a surplus on the net operating balance, a deficit on your cash position might not be a bad thing. This is what the Commonwealth has done. It has built up funds in the Building Australia Fund and such like. When they are spent, the accrual based net operating figure will stay in surplus but, as the spending occurs, that cash position may quite possibly fall into deficit. That is not saying it is bad, because that spending is being made from funds which have been retained because of the booming economy.

Senator FORSHAW—What do the agencies use, or what do they do, to determine the ratings or to consider changing a state government's ratings from AAA to AA or vice versa?

Prof. Wines—They would look at all of them to get a picture. It is not as if they would just work on one or the other.

Senator FORSHAW—I assume they would. But does one have far more relevance than the other for them?

Prof. Wines—Not really, because they are showing different things. The net operating balance shows just the figure on recurrent revenues and expenditures, whereas if a state does borrow excessively then the rating agencies will be concerned about that even though they have a healthy surplus. So it is looking at the figures in their entirety to get a picture of whether that instrumentality is leading to a higher risk level that would then reduce their rating.

CHAIR—Is it a big job to work out what the Victorian outcome would have been on the accrual accounting basis?

Prof. Wines—No. If I had the budget in front of me, I could do it.

CHAIR—Would you mind doing the figures and sending them to the secretariat in an email so that we have a practical example of the differences that you are alerting us to?

Prof. Wines—Yes, I am happy to do that.

CHAIR—Again, thank you very much for your submission, which, as we have all commented, was very comprehensive. We very much appreciate it. Thank you very much for your time and for coming along and talking to us.

Prof. Wines—Thank you.

Committee adjourned at 2.09 pm