



COMMONWEALTH OF AUSTRALIA

# Official Committee Hansard

## SENATE

SELECT COMMITTEE ON STATE GOVERNMENT FINANCIAL  
MANAGEMENT

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

TUESDAY, 20 MAY 2008

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

**Tuesday, 20 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, 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 9.54 am**

**CHAIR (Senator Ian Macdonald)**—I declare open this third 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. The committee has received some 39 submissions. They have all been authorised for publication and are available on the committee's website. These are public proceedings, although the committee may agree to requests to hear evidence in camera, should that be required. I remind all witnesses that in giving evidence to the committee they are protected by parliamentary privilege and all that that entails.

[9.55 am]

**BLAKE, Mr Howard Michael, Auditor-General, Tasmanian Audit Office**

**CHAIR**—Thank you for attending, Mr Blake. We appreciate that you are very busy and we are very grateful to you for your submission and for the time you have made available to us. Would you like to make an opening statement, after which the committee will ask some questions.

**Mr Blake**—Thank you for the opportunity to meet with you. I was only going to add a couple of things to the submission that I made. Since I wrote to you, I have been kept informed by the state Treasury on developments with the Commonwealth Treasury's SPP working group. I have read their first circular and I support the direction in which it is going. I have circulated a copy to my colleagues around Australia—I asked if I could do that. The point I have emphasised to them is that I think there should be some consultation with auditors generally as we finalise that approach. I still think there could be some improvements to the accountability or the auditing part of that process.

**CHAIR**—What is the direction in which it is heading that you agree with?

**Mr Blake**—There is a very good summary of their paper in paragraph 51, which talks about having an approach which is more outcomes-output focused than input focused, and I think that is a good way to go. So, in other words, the Commonwealth is not just handing money over in terms of paying for inputs but wanting to make sure that there are deliverables through inputs and outputs achieved by the jurisdiction for which the funding is intended. I support that approach.

**CHAIR**—Is the inquiry into the special purpose payments a nationwide inquiry or is it just in this instance being done by the Tasmanian government?

**Mr Blake**—I cannot answer that. I thought this was a Commonwealth initiative. I cannot answer on what the other states are doing; I just know what my state is doing. They have been very kind in giving me access to information and allowing me to initiate that with my colleagues. I think it is consistent with the way the states have gone generally. In our own state of Tasmania, we have gone towards an output based framework, both budgeting and reporting, and I support that approach as well because I think it is more transparent. I am very conscious of the need for governments to show what they achieve with the funding that they appropriated rather than what it got spent on. For example, it is no good saying, 'We spent it on salaries and wages.' What you delivered with the money rather than what you spent it on is much more important.

**CHAIR**—Yes, indeed. Yesterday we had some evidence from several academics, one of whom was Professor Wines, who spoke about the need for all states and the Commonwealth government to have a financial reporting standard. He mentioned—I am trying to look it up, and someone might help me—that there is a new standard being developed called AASB 1049. Are you familiar with that standard and that argument, and do you agree with it?

**Mr Blake**—I am familiar with it and I had some input into the one that has been put together as an exposure draft. I support the fact that there is a standard; there has been a standard in the past, but it was not as strong as the current one. The standard will require general government sector reporting as well as whole-of-government reporting, and those reports will be tabled at the same time. They have moved governments away from the GFS framework, the government finance statistics framework, which I think is still a reported framework, so there needs to be some reconciliation between the two because that makes up the international reporting obligations and the ABS requirements. But the fact that there now is a standard that we are all going to be under is a plus. The standard setters in Australia have tried to develop standards that are sector neutral. I think, whilst there is a need for the public sector to have its own standards, it should not vary too much from what the corporate sector is reporting; however, this is an attempt to recognise that the public sector is different and to have a framework for us to be reporting against, and I support that.

**CHAIR**—Are you aware, or is it within your jurisdiction to be aware or have a say on, whether the Tasmanian government is going to adopt that new standard?

**Mr Blake**—I am aware. I was told just this week that they are going to early adopt. I think that is a really good initiative on their part. They will be one of the first ones to adopt the standard. It is only in place for the years, commencing 1 July. So they are going to try it this year, and that impacts on me because I have got to audit the numbers. They then have to look at the comparative figures, which have to be included in the same framework so there is some continuity of the numbers. The answer is, yes, I am told they are going to adopt it. I think it is good that they have.

**CHAIR**—Bringing this down to a level that amateurs can understand: my understanding from the evidence we have heard so far is that some governments report on a receipts and income basis. Other governments report on receipts and incomes and capital. They have different names. I think the last one is the accrual basis. The other one is cash, or the Australian financial standard or something. I do not know. You tell us; you are the expert.

**Mr Blake**—I will not claim to be the expert, but jurisdictions have moved away from cash accounting to what is called accrual accounting. I think the move towards capital maintenance accounting has not hit us yet, so I will stick to cash and accrual. In this state we do both. The Tasmanian jurisdiction is provided with the public account statements, which are cash based reports on general government sector. So if members of parliament and others want to know what has happened with the cash that was appropriated, it is in the report which I audit. In addition to that, they prepare the outcomes based statements, which pick up all of the standards that currently apply—but recognising that in the past it has been government finance statistics or uniform presentation framework based. Accrual picks up 90 per cent of what the private sector are doing. In our case, we provide information in both sorts of reports. In addition, we then go a stage further and prepare the whole-of-government financial statements, which are prepared under the Australian accounting standards. There is a bit of a mix there, and the benefit of this new standard will be to bring all those together.

**CHAIR**—The state budget has come down.

**Mr Blake**—Yes.

**CHAIR**—What was the bottom line reported to the media?

**Mr Blake**—No, the state budget has not come down yet. It is due in the middle of June, so it is a couple of weeks off.

**CHAIR**—When it does come down, in which terminology will it be framed?

**Mr Blake**—I cannot tell you what this year's will be, but last year's was a GFS based framework, which was accrual based, not cash based.

**CHAIR**—Will that be comparative to the Commonwealth outcome in this current year's budget?

**Mr Blake**—As far as I understand the Commonwealth one, yes.

**CHAIR**—The Commonwealth had a \$22-odd billion surplus. Whether the Tasmanian government will report a surplus or a deficit will be on the same basis—

**Mr Blake**—On the same basis.

**CHAIR**—or was last year and you would expect it to be the same this year?

**Mr Blake**—If the Commonwealth is still under the UPF framework, then, yes. But I do not know the answer to that.

**Senator BUSHBY**—Mr Blake, I will just follow on from there. I am no expert in this, but I heard yesterday, and I recall reading it at some point in the past, that there are three different ways that you can actually report a state government or a government budget. Does that ring a bell with you?

**Mr Blake**—Currently, yes. For example, my understanding of the Victorian situation is that they prepare their budget on an Australian accounting standards framework. In our case, we prepare it under a government finance statistics basis or a UPF framework.

**Senator BUSHBY**—What does that mean in practicality?

**Mr Blake**—There is a difference in the way that the ABS work out what accrual accounts they require. That is based on economic flows rather than accounting flows. To give you a very simple example: if we provide for a doubtful debt in our case, because we think a debt is not recoverable, we make provision for that and reduce our profit accordingly. As I understand it, the UPF framework does not recognise provisions for things such as doubtful debts, and it does not therefore allow that to be charged against the profit. In the Commonwealth case, I gather there are differences with the way they treat defence assets. Other examples would be revaluations of assets. They are recognised in the current framework but I gather not in the UPF framework. So there are a number of differences.

**Senator BUSHBY**—At a broader level than that, though—and I may be misunderstanding this—yesterday we heard evidence in Victoria that said the Victorian state budget reports its

budget bottom line based on the difference between its recurring expenditure and the expected revenue that it will raise. That was something like \$828 million. But that did not take into account its capital expenditure. They are saying that it had an \$828 million surplus but, if you took the capital expenditure, it was probably a different figure. Apparently the Commonwealth budget includes its capital expenditure, so its bottom line is not directly comparable to the Victorian bottom line in that sense. It was pointed out to us, for instance, that in the funds that have been set up in the most recent Commonwealth budget—the infrastructure fund and the health fund—millions of dollars have been poked away and, if they start spending down on that capital in later years, it could actually show up as the Commonwealth being in deficit when it is not actually in deficit; it is just using its money. That is because of the way they are accounting for it. How does Tasmania fit in with those two examples?

**Mr Blake**—I cannot comment on the other jurisdictions, but in our case the operating statement that they report—and this is the outcome rather than the budget—has two lines in it, one being the net operating result, which is after depreciation has been taken into account but before asset replacement. Bear in mind that this is only the general government sector. This does not pick up the government businesses. A further line shows the impact of taking depreciation out and replacing it with asset replacement and arriving at a fiscal balance which is after the asset replacement. In our case, I think we are showing both. So the effect of capital investment at a general government sector level has been shown on the operating statement.

**Senator BUSHBY**—In your submission you have drawn attention to the need to manage the fact that staffing costs are increasing at rates higher than revenue growth. Are those staffing costs more to do with salaries or staff numbers? Where do you see the costs rising?

**Mr Blake**—It is both. If you look at my last report, I highlighted that the numbers of FTE are growing and the salary costs are growing. I think there are good reasons why the money is being spent primarily in the education and health sectors and that has been well documented in this state. All I am trying to highlight is that, if that trend continues and your expenditure growth is higher than your revenue growth, at some point you hit a negative situation. It is both FTE and cost.

**Senator BUSHBY**—Does Tasmania have a charter of budget honesty?

**Mr Blake**—It is not called the same thing but it has got legislation and it does document in its budget papers five or six fiscal targets, which I think, again, is a good initiative. Those are reported against in the final outcome statements.

**Senator BUSHBY**—How does that work? You may not be aware of the answer to this, but how does it compare with the Charter of Budget Honesty that operates at a national level?

**Mr Blake**—I do not know the answer to that. I did a survey, just for my own use, a couple of years ago on the different legislation in Australia, but I cannot recall what the differences are.

**Senator BUSHBY**—What about unfunded superannuation debt? How is that dealt with in the budget at the moment?

**Mr Blake**—It is a significant liability in the state, and it is growing, because of a number of factors. The state government has, as I understand it, decided to try and eliminate that liability by 2033 or thereabouts. That will change from time to time. That was changed from a 2018 target some time ago. My view is that they are taking steps to deal with it. It is a growing problem, as economic circumstances change. It might in fact come down this year because of the higher interest rates.

**Senator BUSHBY**—But how are they dealing with it? What are they doing?

**Mr Blake**—They are setting funds aside every year into a fund to pay for this amount. It is intended that by 2033 it should be eliminated, based on current forecasts.

**Senator BUSHBY**—How is the liability accounted for in the budget papers?

**Mr Blake**—It is in the budget papers, through the accrual balance sheet. It is in the outcome statements as a liability that appears on their balance sheet, which it is expected to. The expense each year is shown in the whole-of-government accounts as an expense. In the GGS accounts it does not appear as an expense, but it does appear in the equity. The amount is transparent. You can find the growing cost and you can find how it has hit the bottom line.

**Senator BUSHBY**—What is currently the level of debt in the state government? Are you able to give us any figures on that, both the general government sector and—

**Mr Blake**—Yes. The net debt figure last year was \$409,000, but that is positive—sorry, \$409 million. That is a positive net debt figure, and it has been for a couple of years in Tasmania.

**Senator BUSHBY**—Is that the general government or does that include the non-government sector as well?

**Mr Blake**—That is the general government sector only. They do not report net debt in the case of the GBE.

**Senator BUSHBY**—Do you know what the debt levels are of the GBEs?

**Mr Blake**—That is in my report. I will have to look at the notes to tell you what they are.

**Senator BUSHBY**—Would you take that on notice.

**Senator CHAPMAN**—Could you table the two reports that you refer to in your submission for us.

**Mr Blake**—Yes. I will leave this one I have with you, if you like.

**Senator CHAPMAN**—Thanks.

**Mr Blake**—They are both here. I will leave those with you but I will refer to them while I am talking. I will take it on notice, because I have to make sure I have the right number.

**Senator BUSHBY**—That will be fine. Do your responsibilities also cover providing audits for the hydro?

**Mr Blake**—They do.

**Senator BUSHBY**—One of the things you have just taken on notice is the debts of the GBE. They include the hydro. Are you familiar with what their debt level might be?

**Mr Blake**—Off the top of my head, it is in excess of \$1 billion. I can give you that exact number offline. One of the things I referred to in my submission was that I do make a comparison each year of the results of the three power entities in Tasmania, and that highlights the differences in the debt levels and discusses the debt ratios and other things. That information is in my report every year. I have chosen to do that to try and make sure that the comparison between the three entities is more transparent.

**Senator BUSHBY**—Do your responsibilities, when you do audit, include looking at the viability of the organisations? Do you consider if they would be able to meet their debts as they fall due et cetera?

**Mr Blake**—The auditing standards today require me to form a judgement about going concern, so we look at that for all entities, not just the hydro. In the first instance, though, it is up to management or the board to make sure that they satisfy themselves of that—

**Senator BUSHBY**—They have a lot of the same responsibilities, yes.

**Mr Blake**—They conclude every year and they state in their opinion that they can pay their debts as they fall due. I have no doubt, based on the June 2007 statements and audits that I did, that the hydro is well capable of meeting its debts as they fall due. I cannot comment on the current situation.

**Senator BUSHBY**—No. As you know, in the media at the moment there are suggestions that they need a capital injection from the government to be able to continue to provide the services that they provide, which obviously is a different thing to whether they are able to meet their debts as they fall due.

**Mr Blake**—I am not sure that is quite what they are saying. There has been speculation for some time now that the hydro needs an equity injection. I am not saying whether I agree with that or not; I have simply shown the comparative positions for the three entities. I am not sure whether they need the equity to continue to operate. There is a different reason for that, but I speculate.

**Senator BUSHBY**—To ask a slightly different question on the hydro, are you aware of the value of the dividends that the state government has withdrawn or demanded out of the hydro in the last 10 years?

**Mr Blake**—I am aware that there was a dividend policy which was taking dividends out of the hydro up until about 2002-03. That policy has changed since I have been here, so I cannot comment on the past.

**Senator BUSHBY**—Okay.

**Mr Blake**—In more recent times there has been a dividend policy taken on board for all of the GBE state owned companies, which looks at averaging rather than what the profit is in a particular year. I think that was a good initiative. In my time the dividends have not been as high as in the past.

**Senator BUSHBY**—What do you mean by averaging?

**Mr Blake**—One of the things that we have found with the move to the new Australian accounting standards, which are now internationally based, is that there have been fluctuations in the profit result. There are new things that have to be reported and brought to account. The hydro are certainly in that case, so their profits go up and down. That is why cash is important as a consideration in analysing their performance. It is not just the book profit; it is the cash profit that is important. So in recent times, because of the fluctuations in those results—and I will give you another example of the motor accident board here, where in recent years their results have been particularly strong because of the strong stock markets—to base a dividend on one year's profit is not really the right thing to do. To use it based on six or seven years of profits, when markets go up and down or other factors can be smoothed out, if you like, gives you a better feel for what their real results are over a period and therefore what the dividend should be.

**Senator BUSHBY**—Are you saying that the dividends that the government takes out of its government owned businesses are based on an assessment of the profits? In other states we have received evidence that says that, when the government takes dividends out of a government owned enterprise, it is not necessarily a reflection of the profit that that enterprise has made; it is more a consideration of what the government thinks it should be paying it.

**Mr Blake**—It would be wrong for me to comment on what the government's policy is in that regard. But I would suggest to you that they have taken it based on profits and that those profits—and I cannot talk about the past—are averaged over a certain period. I think that is a better way to do it, because at least you are considering profits over more than one period. But I would be surprised if they were taking a dividend based on anything other than profit.

**CHAIR**—Can I clarify a couple of things from your answers to Senator Bushby. When you said the deficit is positive, what did you mean by that?

**Mr Blake**—I have always found the way they report it odd. If you look at the Treasurer's annual report last year, the net debt is shown as \$409 million, with brackets around it. When I look at a figure in brackets, I always think it is a liability, a loss or a deficit. In this case, the bracketed figure represents a positive.

**CHAIR**—So does that mean it is a surplus?

**Mr Blake**—It is a surplus—there are greater financial assets than there are debt in this case.

**CHAIR**—Does that take into account the superannuation payments that Senator Bushby raised?

**Mr Blake**—No, not in net debt. In the calculation of net worth or net financial liabilities, net debt is taken into account, but in the calculation of net debt it is not.

**CHAIR**—If you included the superannuation in the net debt figure, would it be a positive or a negative?

**Mr Blake**—It would be a negative.

**CHAIR**—Could you give us a ballpark figure of what the deficit might be?

**Mr Blake**—The superannuation liability at June 2007 was \$3.6 billion. The net debt was \$409 million, so, if you take one from the other, the deficit is about \$3.2 billion. But I think the difficulty with that argument is that you are taking into account the superannuation liability but you are not taking into account the non-financial assets of the state, and the non-financial assets are worth \$8 billion plus. Your point is valid, but I think looking at the impact of superannuation in isolation is wrong; you should take into account the other assets.

**CHAIR**—But if the superannuation debt had to be paid out today there would be a \$3.2 billion deficit in the state budget.

**Mr Blake**—Yes. But—

**CHAIR**—You are not going to have any public servants left if you are paying it out today, but, in an accounting way, shouldn't that be reported?

**Mr Blake**—It is reported; the information is on one page and the reader can make the sorts of calculations we have just made. If they wanted to say what the impact of the superannuation liability on the net debt was, it could be done. Therefore, it is transparent, in my view.

**CHAIR**—I assume all of the government business enterprises that you have mentioned are, again, in layman's language 'guaranteed' by the state government so, if they fall over and go into liquidation—which I am not for a moment suggesting they will—the state government is required to pay any debts.

**Mr Blake**—I am not sure that there are formal guarantees in place. We have a treasury corporation which funds those organisations and there are arrangements between them, loan covenants and so on. Those entities are established either under the Corporations Act or under government business enterprises legislation. But I suspect you are right: ultimately, if they get into difficulty, somebody has to get them out. I do not believe that is the case today, but that could be the case. I am not sure that there are formal guarantees in place. I would have to take that on notice.

**CHAIR**—Okay. I do not know what the position of these GBEs is. But, to get an overall layman's view of the state of the Tasmanian finances, is it reasonable to suggest you need to have the current situation on the government expenses, but including what the government might be responsible for—that is, funded super, plus GBE debts. Is that a correct assumption? If someone asked how Tasmania or Victoria are going financially, you would really have to get an assessment of all of those factors, would you not?

**Mr Blake**—Yes, and that is why the whole-of-government statement which they prepare provides that information.

**CHAIR**—Did you say you audited that?

**Mr Blake**—I did.

**CHAIR**—You do audit the whole-of-government statements?

**Mr Blake**—I audit each individual entity and the whole of government.

**Senator BUSHBY**—That is at the end of the year, as opposed to the budget?

**Mr Blake**—Correct.

**Senator BUSHBY**—So you do not audit the budget.

**Mr Blake**—No, I do not.

**Senator BUSHBY**—But you audit the financial figures at the end of each financial year.

**Mr Blake**—The outcome. That is right.

**CHAIR**—What does that show? Could you again give us a broad figure?

**Mr Blake**—The consolidated statements, rather than the general government sector statements?

**CHAIR**—Yes.

**Mr Blake**—They showed that at 30 June 2007 the total equity of the state was \$9.6 billion. That suggests that the assets are greater than the liabilities, including the superannuation liabilities, by almost \$10 billion.

**CHAIR**—Okay.

**Mr Blake**—Bear in mind that the assets there include the hydro and all of those sorts of things.

**CHAIR**—And roads and railways.

**Mr Blake**—And parks, and all those things, many of which are very illiquid.

**CHAIR**—Illiquid, yes. Sorry, I was clarifying that.

**Senator KIRK**—Thank you, Mr Blake, for your comments here today. We have been talking a bit about government business enterprises. I noticed that in your submission you said that you

supported and contributed to a review in 2007 conducted by Tasmania's Department of Treasury and Finance into ownership and governance structures of GBEs and SOCs. Can you tell us a bit more about that review? Has it been completed? Is there any report or any outcomes that have emerged from that?

**Mr Blake**—I do not know the answer, I am afraid. I do not know if it is finished and I do not know if there is a report. There was a previous equivalent document that talks about policies around how it manages and establishes its government businesses. That review was simply an update of that document. What it was trying to do was to say: 'The whole governance world has changed in the last five or six years, for very good reasons. Let's get our policy framework up to date.' They gave me a copy and I gave them some comments. I do not know what the status of that document is now.

**Senator KIRK**—Were you asked to comment on a draft or were you asked to make a submission to the review?

**Mr Blake**—I was given a copy of the draft and asked to make some comments.

**Senator KIRK**—When was that in 2007? I am trying to get the timing.

**Mr Blake**—I would be guessing. It was some time last year, sorry.

**Senator KIRK**—That might be something that we need to follow up with somebody else to find out what the outcome was. Also, in relation to the special purpose payments made by the Commonwealth to the states, you said that from your discussions with others you have determined that there is a review being undertaken by the Commonwealth. Do you have any idea where that is up to or how that has been initiated?

**Mr Blake**—You would be better off asking Treasury that question. I know that it is progressing during this calendar year. I cannot recall the exact finish date.

**Senator KIRK**—You make a number of points on page 3 about what you consider such agreements ought to contain. Is that a reflection on what is happening at the moment? Are these your ideas for improvements to existing weaknesses? Where does that fit into the context of this?

**Mr Blake**—I mentioned before we started that I was recently asked to do an audit for an acquittal from a public sector entity here to the Commonwealth, based on some funding that had been provided. It is common practice for the Commonwealth to require an acquittal of some sort and for that acquittal to be audited. In this case, the funding was provided in 2003 and we are only now being asked to do the acquittal on the basis that they are not going to give us any more money unless we provide it. I thought to myself that it is great that the acquittal is required, but it is a bit late. In my view, those things should be built into agreements. It should be absolutely clear that an acquittal of some sort is required. It would be good if the auditor doing the audit—I am not saying that I need to be the auditor, but somebody needs to look over those numbers to provide assurance—did it in a timely way.

My experience of those acquittals has tended to be: ‘We gave you a million dollars. How did you spend the million dollars?’ They say, ‘We spent it on this, we spent it on that, we spent it on a few other things and we delivered the outcomes of the project.’ But what were the outcomes? That is not always clear. The new framework will make the outcomes much more clear before we sign these agreements, and there will be some acquittance against them. ‘What did you deliver?’ and ‘What did you achieve with the money’ will be the questions asked, rather than just ‘What did you spend it on?’ That is in line with the comments I was making earlier. That is where this is heading. That is great. There should then be a requirement that that is built in to the documentation so that if a copy comes across my desk I know that I am going to have to audit those numbers at some point and I am not just going to audit the financial numbers but what the deliveries were.

That changes the audit process. That changes the way I go about looking at those and it changes the reporting mechanism for what is being reported rather than the traditional profit-loss account, if that is the right way to put it. So I think some of those things need to be thought about—I am not saying that they are not; I am encouraged that they are.

**Senator KIRK**—I take it then from your comments—and I think they sound like very good ideas—that you have not been formally approached in any way by any Commonwealth body, whoever the Commonwealth body is, that is reviewing these arrangements to make a formal submission.

**Mr Blake**—I am not saying we have to be. That is the Commonwealth’s call. In my last email to the local Treasury, I suggested that perhaps as part of the documentation there should be a requirement for the Commonwealth Auditor-General to be consulted and that these two make sure that—in this case it is a he—Mr McPhee is aware of what is being discussed, which may impact him later. I think it is always useful to get all of the parties involved in this process to make sure that you get it right.

**Senator KIRK**—From what you are saying, the state auditor-generals will be likely impacted as well, so it would also make sense for them to be consulted in the first place.

**Mr Blake**—When—I am not sure which period it was—one of the triennial health agreements came out, there was a requirement for an annual acquittance, and the health department affected could choose to appoint a private auditor to do that work, but at least that was included as part of the agreement. We knew that there could be a process that we had to follow because we had a profit and loss type acquittal rather than an outcomes based acquittal. That is okay—I think we are moving forward in that respect. I think we should be part of the process.

**Senator KIRK**—That makes sense.

**CHAIR**—Just before you get off that, Senator Kirk, thanks for raising that. Although, as the Auditor-General mentioned, it is not specifically part of our inquiry, I think the suggestions sound reasonable and perhaps it is something that the secretariat might be asked to consider as a recommendation later on.

**Senator CHAPMAN**—Some of the evidence we have heard in other states is that state governments are in effect hiding some of their recurrent expenditure by describing it as capital.

In particular, some of their maintenance expenditure—schools and the like—which really is current expenditure is being put in the capital column. Are you aware of the extent of that if that happens here or the extent that it might be happening with state governments generally; and is it something that you are able to pick up as an auditor and report on and highlight?

**Mr Blake**—I do not believe it is happening here. I certainly have not come across evidence of that. As part of our audit process, I look at the distinction between capital and revenue expenditure, and we are very conscious of the need to make sure that that separation exists. The accounting standards are specific in that case. The accounting standards define what can be capitalised into an asset and what cannot or what should not. In order for me to make sure that I can ensure that the agencies or the state as a whole are complying with those accounting standards, there are audit processes that I follow to make sure that they have understood the difference. Sometimes it is quite difficult to separate that difference—has expenditure enhanced the future life of an asset or has it enhanced the capacity of the asset to provide services that are better than before? In that case, you capitalise the expense. We do the same in local government because in a lot of cases wages are capitalised, for example, and we have a very good look at why they are capitalising those costs. I cannot think of instances where we have found evidence that that is happening on any broad scale at all. In my case, for example, the department of infrastructure is an important one in this respect because it manages road expenditure. They get appropriated capital, and some of that capital, which can be hundreds of millions of dollars, would be spent on maintenance. We have had a good look at the distinction between the two, and I have not found evidence that they have fudged it, if you like.

**CHAIR**—How can maintenance ever be a capital item?

**Mr Blake**—It should not be, so the fact that it may be an appropriation and then spent on maintenance in my view is okay because as long as you get the accounting right, I am happy. If the appropriation is: ‘Here’s the \$100 million,’ or whatever it is, to make sure those roads are going, and some of it is intended to replace the road or to make sure the road is in the right sort of condition, and we get the accounting right, I am happy. My view is that they get their accounting right.

**CHAIR**—Sorry, I do not understand that. This was, I thought, the point Senator Chapman was making: that maintenance must be a recurrent expenditure but it is shown in the budget as a capital expenditure.

**Mr Blake**—I have to go back to what the budget says. Maybe what I am trying to say is that if that item is going through as a capital expense in the outcome statements, I am happy that they have been properly classified between capital and maintenance costs. I would have to reflect on what is in the budget. In this state in the department that I am talking about we are required to show and explain what has happened between budget and actuals so that the user of those accounts can see what has happened to the money, both in terms of the capital appropriation and the revenue appropriation.

**CHAIR**—But when you are reporting on government bottom lines, if things like maintenance are put in the capital column—and that is exactly the point I thought Senator Chapman was making—

**Mr Blake**—I am saying that, in my view, that is not happening. The maintenance expenditure that is genuinely maintenance expenditure is being charged against expenditure—so it is seen in the profit, or the surplus. If there is expenditure that I would regard as being capital, and it should be capital, it is going to capital.

**CHAIR**—I am not following. I thought you said before that in that particular department some of the funds that were given for capital works were used for maintenance. Did you not say that?

**Mr Blake**—I would have to reflect on what is in the budget papers. I look at it to see what money was spent and if it has been properly classified for it to be capital or maintenance. In that case I am satisfied that it has been properly allocated in the outcome statements.

**CHAIR**—So you are saying that it is shown as a capital item but when it is reported on at the end of the year it is shown as a revenue item.

**Mr Blake**—I have to reflect on what is in the budget papers.

**Senator CHAPMAN**—Or are you saying that there are two lines here: the capital and the revenue. And you are saying that, as far as you are aware, the maintenance expenditure is actually being accounted for against revenue.

**Mr Blake**—That is right—which is what it should be. I am not that concerned about what the budget calls it. I am concerned about what the outcomes call it, because I want to make sure that the way the money has been spent, and the purpose for which it has been spent, has been allocated in the right place. And I am satisfied that that has been the case.

**CHAIR**—But you cannot have a genuine bottom line if recurrent expenditure is reported to the Tasmanian public as being a capital expenditure.

**Mr Blake**—No, it is not. That is what I am saying. In the outcomes statements I am satisfied that recurrent expenditure has been recorded as recurrent expenditure.

**CHAIR**—These are not trick questions of course—

**Mr Blake**—No.

**CHAIR**—but you said you might have to look at the budget papers. If there is anything you want to add, could you drop us a note on that—

**Mr Blake**—I am happy to do it.

**CHAIR**—because I still confess to being a little confused. But that may well be me rather than what you are telling us! Thank you.

**Senator CHAPMAN**—So you are saying in effect that, as far as you are aware, maintenance is not being funded out of borrowings; it is being funded out of revenue?

**Mr Blake**—Out of current appropriations. Yes.

**Senator CHAPMAN**—Right.

**Mr Blake**—And the general government sector. I would have to focus in and look at some of the government businesses, but my view is that the accounting for it is appropriate.

**Senator CHAPMAN**—In terms of government borrowings, are there areas where those borrowings are used for what you might call short-term expenditure rather than long-term expenditure—short-life projects rather than long-life projects—given that most of your borrowings are paid for over a generation or two and the general principle is that the people getting the benefit from those borrowings should be the people who pay it off over time. If it is a short-term project or short-term expenditure, then you have got people paying for it over the long term who may not get the benefit.

**Mr Blake**—I hear the principle in what you are saying. I cannot answer you directly. Our state government has not been borrowing because it has been in a net debt positive situation. So we have not had to borrow to fund the new prison, for example, which we built a couple of years ago. In fact in that case there was a small amount of borrowings—\$30 million—which is being paid off over a lengthy period. But in general we are not borrowing.

**Senator CHAPMAN**—That leads me to another question. If you build a prison, which can have a fairly long life, shouldn't that be funded out of borrowings and paid for by the generations that are going to get the benefit of it, rather than today's taxpayer paying for that project.

**Mr Blake**—Well, that is a really good debate. I do not want to get into this government's policy of how they borrow or how they fund a future hospital, for example. That is a policy decision that they make. My own view is that intergenerational equity is important. We have the debate often in local government: should councils borrow to build new assets? My own personal view is that they should. Put it this way: I do not think that there is anything wrong with borrowing if it is going to benefit future generations. The idea that we should have no debt, I think, is unrealistic. But that is a policy decision for the government. That is just my personal view.

**Senator FORSHAW**—Firstly, apologies for missing most of your evidence. Can I leave you with a question that you can come back to us on. Firstly, have you read or seen the submission that has been made to this inquiry by the Tasmanian opposition?

**Mr Blake**—No, I have not.

**Senator FORSHAW**—It is a public submission. There a couple of sections in that submission relating to superannuation and how it is provided for within the state accounts and how certain assertions are made. There is also another section which deals with off-balance-sheet finance in a state owned incorporation. Without going into detail, the suggestion is that they are not being properly accounted for, or they are being done in a way to give a favourable impression to the state's financial and economic position. I would appreciate it if you would have a look at the

submission. We will get a copy to you. We can probably give you a copy today, and maybe you could respond with some comments on whether or not they are accurate.

**Mr Blake**—I will do that. Thank you.

**CHAIR**—That would be good. They are the sorts of questions that I was asking you before.

**Senator FORSHAW**—I apologise if I have gone over old ground.

**CHAIR**—No, that is fine.

**Senator BUSHBY**—You just mentioned that the state government is in the black and that it is not borrowing money at the moment. But it certainly did have significant debt about 10 years ago. As I understand it, and certainly as the various Treasurers over the years have put it, one of the things that has helped them to pay that off is the fact that they have taken quite substantial dividends each year from various government business enterprises, most notably the Hydro. You also acknowledged earlier that GBEs continue to have considerable debt. I think you mentioned that the Hydro has over a billion dollars in debt. Is it possible that the GBE debt has, in part, been created or sustained through the policy of taking dividends? Basically, has the government effectively paid off its debt by transferring some of that across to the GBEs—not directly, but in a roundabout way?

**Mr Blake**—I would have to pass on that. I cannot comment on what happened before I came. I was aware that dividends were being paid. Were those dividends excessive? My predecessor did not comment and I am not going to comment. I analysed the financial statements of all of the government businesses, including the Hydro, every year. So my reports, which I will send you copies of, cover that for every audit in the state. I comment and compare their debt equity levels and other ratios with what happens with other jurisdictions and I compare them with like organisations. I look at the Productivity Commission consideration of those sorts of government businesses.

I raised issues about risk, cash flow and so on about some of those, but I have not at this point said that in my view the debt is too high. I have not said that the debt-equity ratio is not the right one or that the interest cover is not the right one. I have simply noted what they are and that there are risks associated, particularly, with the Hydro. It would be wrong for me to say—because I do not think it is right—that their debt is too high. Their debt is high. Is it too high? In my view, no, compared to other, similar type organisations.

**Senator BUSHBY**—But they still have debt. I am asking whether it is possible that if, say, over a period of five or six years the state government took \$200 million in dividends out of the Hydro, that means that is \$200 million that they could not pay down their debt with. They have taken that \$200 million and paid it off their debt, but the Hydro did not have that flexibility.

**Mr Blake**—Yes and, again without commenting on the amount of the dividend, I would argue that you establish government businesses and state owned companies to make a profit. You expect that they are going to pay a dividend. Is the dividend too high or too low? Could they have used that money to repay debt or to reinvest in infrastructure? Those are all questions that I think are fair to ask.

**Senator BUSHBY**—I would probably argue for a slightly different reason for establishing most of the GBEs: that it was more for the public good initially, but if they make a profit in the end then that is a very nice thing. But they have been established primarily—certainly initially—to provide services that would not otherwise be provided in the private sector.

**CHAIR**—Just for interest's sake, is Forestry Tasmania—an organisation I was once associated with—a GBE?

**Mr Blake**—Forestry Tasmania is a GBE.

**CHAIR**—Is it?

**Mr Blake**—Yes.

**CHAIR**—Does it contribute dividends to the government?

**Mr Blake**—It makes a profit. It does not make a huge profit. I am doing a review of that very matter right at the moment. It pays a dividend, but it has not always paid a dividend. I think that in the last couple of years it has not paid a dividend, but I would have to take that on notice. It is a government business enterprise; it is expected to pay a dividend. I do not think it has in the last couple of years.

**CHAIR**—This is not a question for you, but is there any talk of privatisation? Can you, as a local, tell me?

**Mr Blake**—There is speculation all the time about different government businesses, but not Hydro specifically that I am aware of.

**CHAIR**—Do you audit fully the books of Forestry Tasmania?

**Mr Blake**—I do.

**CHAIR**—They have a fairly substantial asset base—is that correct?

**Mr Blake**—Yes. It would be in excess of \$300 million, primarily comprising the native plantations, the plantations, the amount of forest, the road networks that they have constructed and so on. They have a fairly large land base. So, yes, it is a big asset.

**CHAIR**—Their records are obviously publicly available.

**Mr Blake**—Yes, they are.

**CHAIR**—Thank you very much, Mr Blake, for your time. We are indebted to you. There are a couple of matters that you might get back to us on. Thank you very much for giving us your time and your expertise.

**Mr Blake**—Chair, I know I said I would give you these reports, but I will not because they have got my scribbles in them. I will get you some originals.

**CHAIR**—Yes, if you would not mind sending them to the secretariat that would be great. Thank you very much.

[10.43 am]

**WADSLEY, Mr Alexis Gordon Wright, Lecturer and PhD Student, School of Economics, University of Tasmania**

**CHAIR**—I next welcome Mr Wadsley as a visitor to our inquiry. Thank you very much for coming along and for your submission. I am not sure if you were here when I commenced the hearing, but I will just remind you that this is a committee of the parliament so you are protected by parliamentary privilege. If there is anything that you are reluctant to talk about or answer questions on in public, we can go in camera.

I thank you for your submission but say, ‘Thank heavens you’re here,’ because as an amateur and a layman I found that it had some references and comments that were a little over my head. But I am very interested in learning from you about your view on these things. Perhaps you could give an opening statement, briefly recapitulating what you have written to us, and then subject yourself to questions.

**Mr Wadsley**—Thank you very much for inviting me to attend. The submission that I have put forward is basically one of the key policy outcomes of my thesis research. I have been undertaking a PhD at the University of Tasmania for the last 3½ years or so under Dr Bruce Felmingham, who is a senior researcher and economist at the faculty and fairly well known in Tasmania. That research has focused on the relationship between the terms of trade, exports and others metrics in the real exchange rate for the Australian economy. The main policy conclusion that came out of that was that the real exchange rate was heavily driven by the terms of trade and that there was a strong relationship between productivity in two sectors, the export sector and the non-traded sector—which is how we simplified it; you might think of it as exporting iron ore or making haircuts as a service—and the price relativity between those two sectors was really going to drive the real exchange rate.

From that particular point one sees comments in the media saying that the reason we have not turned around the current account balance is due to a lack of capacity in various export sectors. That does not match with the theoretical research or with what came out empirically. When I looked at it empirically, it suggested that much of the increase in the terms of trade was being absorbed by the real exchange rate. An increase in productivity in those sectors was almost akin to a terms of trade increase. If you get an increase in price of 30 per cent, that is the same as an increase in volume of about 30 per cent. It makes no difference to the current account perspective. So if you are going to improve the current account you need to look at the other side of the equation. The equation in terms of the current account is based, on one hand, on exports minus imports and, on the other hand, on savings less investment. So if you increase savings you can increase your net exports; if you reduce investment you can increase net exports.

When one sees, in terms of the terms of reference, questions like whether we improve capacity constraints by increasing investment, that does not fit with the theoretical model that we have looked at, which seems to hold, based on the empirical research looking at a number of countries comparing Australia to, in particular, Norway and Chile. The interesting feature between Norway and Chile versus Australia was that Norway and Chile have sovereign wealth funds.

That is, when the terms of trade go up, they put a large proportion of the increased income that comes from that into offshore accounts effectively and it is saved offshore. Therefore, it does not come into the domestic economy, it does not inflate prices and it does not cause the sort of negative effect we are seeing at the moment which, in other economies, has been called Dutch disease, where you have a hollowing out of manufacturing sectors and so forth because of high terms of trade and the high real exchange rate that comes with that. So in terms of what Australia should be doing, rather than looking at whether we can invest more in increasing rail capacity for exporting coal, we should be looking at how we should be raising the same rate and whether our savings are being invested appropriately overseas rather than domestically, which would then reduce pressure on the real exchange rate and actually reduce some of those domestic pressures.

**CHAIR**—Thank you for that, Mr Wadsley. That should provide some interesting information for questions, not debate.

**Senator KIRK**—I am still, I have to admit, trying to get my head around your theory. However, it is most interesting. You say that you have looked at empirical evidence and it does support your theory. Where was the empirical evidence drawn from? Did you say from Norway and Chile?

**Mr Wadsley**—This may end up getting pretty technical. I took data from the IMF series—they produced data on different countries in terms of their export shares, their terms of trade, the real exchange rate and so forth—and compared what had happened basically over the last 20 or so years, going back to 1980, between moot changes in the real exchange rate, changes in the export share and changes in the real exchange rate. I then correlated that to background research on how their economies were functioning. That seemed to indicate that, in some of these other economies, we were not getting a strong relationship with the export share because their terms of trade and their export share were moving together, whereas in Australia there was very little correlation between the export share and the terms of trade. That suggested that we were not being effective in saving in response to high terms of trade.

**Senator KIRK**—In the Tasmanian context, how does this translate? What message do we get out of your theory for the way that the Tasmanian economy operates? Where should there be greater investment, savings and the like?

**Mr Wadsley**—In terms of the Tasmanian economy, if we are concerned about the domestic pressures such as inflation and potential closing of various manufacturing institutions, the focus should not necessarily be on increasing more big export industries but in ensuring that we can improve the productivity at the non-trading and import competing sector. That would be where the focus should be, rather than on opening up a major export industry. As I mentioned, the pulp mill has been the major focus of the state government. In my view as a researcher, and in terms of the private economic research on that, that would not necessarily improve the current account balance or improve the level of exports from the economy because of these exchange rate effects.

**Senator KIRK**—So you say that the Tamar pulp mill will only exacerbate supply constraints?

**Mr Wadsley**—Yes. The demand for skilled workers, who will be drawn into that industry—such as concrete workers and people who provide other engineering services—will increase costs to everybody else in the economy, and it would not necessarily result in any improvement in the current account balance.

**Senator KIRK**—So where should the investments be made? In imports?

**Mr Wadsley**—We should look at different areas. Electricity supply would be an important one. We could try to ameliorate price rises. Road transport raises issues in certain parts of the states. There is rail infrastructure. Water infrastructure has become important for various areas. We should ensure that we maintain the infrastructure in all of those areas so that the sector which is competing for labour with the strong exporters from Western Australia has got as much help to do that as can be given to them.

**Senator KIRK**—If I understand your argument properly, the bottom line is that we ought to be investing much more in infrastructure—things like electricity, rail, roads.

**Mr Wadsley**—Or in ensuring that we are maximising productivity. There is a big difference between investment and improving productivity. Just pouring dollars into something will not help at the moment, because that requires us to bring in more construction workers, more concrete et cetera, which exacerbates the supply constraints. The investment has to be smart. You cannot just expect that pouring billions of dollars into the economy and infrastructure will help. You have to work out targets: where is investment in infrastructure going to ameliorate supply constraints in the short term without exacerbating supply constraints by demanding more inputs from the rest of the economy?

**Senator KIRK**—Do you have any ideas about how that productivity could be maximised?

**Mr Wadsley**—Skills is an important area. Using the market as a force for driving the efficient allocation of resources is usually fairly good. For sectors which are looking for a specific handout, that may pose a question about whether that is relationship based or commercially based. Water pricing would always be useful from a theoretical perspective to drive investment in the right areas, the most efficient areas. But looking at skills and ensuring that the electricity grids are maintained are areas to target. Also, where you are getting congestion is a sign that that is the area to target.

**Senator KIRK**—In terms of your theory, how far down the track are you towards finalising it? Have you completed the PhD and submitted it?

**Mr Wadsley**—We are in the zone where it is eight weeks away. The theory is fairly complex. How you mould the argument to make it most easily understood is the question. My supervisor is trying to assist to make it as good as possible. We think that we have broken through in terms of getting the argument clean. We also took the theory out for an outing at the previous conference of economists and we got a fairly good reception there to the research and the theory underpinning it. We are hopefully progressing from that point.

**Senator KIRK**—Have you had a change to let your views be known to government or anyone besides us, such as in Tasmania?

**Mr Wadsley**—In terms of Tasmania, I am happy to assist parties in advising on policies and so forth as opportunity and time permits and so forth.

**Senator CHAPMAN**—Would the Commonwealth Treasury accept the validity of your thesis?

**Mr Wadsley**—Several aspects of it they would. That is suggested by the reported comments on where we should be investing and what the importance is of investment at this time. The argument that it is productivity that we need to focus on rather than necessarily increasing raw exports is a key aspect of price constraints. I think the difference it may come down to is to what extent we accept the Pitchford thesis, which basically says that savings and investments are a product of the market and everybody's individual choices about when they save and when they invest and buy, and therefore the government does not have a role in helping to shape that. Compared to other major resource exporting economies, they have taken a long-term intergenerational perspective that says that we should focus on putting a bit more aside during boom times to ensure that saving so that if we do have a major downturn in terms of trade we are able to support the economy at that point. So, if there is an emphasis on whether we need a state focused, sovereign wealth fund model, that would perhaps make a difference in terms of the way people see international macroeconomics.

**Senator CHAPMAN**—Given that the present government indicated they are going to focus on infrastructure, including the bottlenecks, do you think Treasury will be giving them some contrary advice?

**Mr Wadsley**—I am not in a position to say what they would say. That is their prerogative.

**Senator CHAPMAN**—You talked about skills, road and electricity as areas where investment should be focused, rather than rail and port infrastructure. As an example, wouldn't investment in electricity also produce inflated demand in some way?

**Mr Wadsley**—I will give you an example of a Tasmanian case. There was a steep rise in power prices to domestic businesses and consumers, and that was seen as a sign of meeting capacity constraints for the domestic side of the economy, which really has to compete with labour and the export side of the economy for input. That was a sign that we have reached capacity constraint in that area, which will then exacerbate the real exchange rate and have inflationary impacts.

**Senator CHAPMAN**—Would investment in electricity ease that?

**Mr Wadsley**—I would make that assumption.

**Senator CHAPMAN**—You have indicated ports and rail should be avoided.

**Mr Wadsley**—The question is: is it purely for export or is it about improving the efficiency of the domestic economy? In Tasmania's case, there are a lot of exports and imports between Tasmania and Victoria, and other states. It is very important to ensure that the costs to all Australians are kept as low as possible. If we are exporting goods and services for domestic consumption, then obviously an increased port cost will increase cost inflationary pressures in

Australia, which is what we are trying to avoid. The key issue is: if we are trying to improve exports to the rest of the world, then that is not going to have any impact on inflationary pressures in this country.

**Senator CHAPMAN**—So it is very difficult to draw this distinction, isn't it?

**Mr Wadsley**—Absolutely. This is one of those issues with any theory, as you simplify it to try and work out the kernel of truth and then seek to apply it.

**Senator CHAPMAN**—Are there any clear-cut areas in the current situation that you say we should avoid investing in?

**Mr Wadsley**—If you think about public subsidy to export industries, it would be a waste of funds. They can make their own decisions as to whether they need to invest in that or not. So there is no pressure to actually allocate public funding to that.

**CHAIR**—Like the export market development grants, you are saying they should not be—

**Mr Wadsley**—You would actually have to question at this point whether that money should be allocated in that way. There is a bit of a long-term effect in those grants where you are saying, 'Well, these aren't actually about the current exports today; they're about our export capacity five years down the track.' That becomes a much more complicated question because if you look back over the history, say, in 2000-01, when the Australian dollar was very low, the big boost that you had out of manufacturing exports vindicated the fact of having a balanced economy. Assuming that the terms of trade will move over the cycle, we need to maintain the capacity to export across a range of sectors and not simply focus on major bulk minerals or other key activities, assuming that that will continue forever, because the history would suggest that that is going to change at some point. In terms of supporting exporters in their initial stages, you would say, 'Is this going to help us when the next downturn happens?' If it is simply doing what we are good at at the moment, in terms of LNG or coal or anything like that, then there would not be much point from a public funding perspective.

**Senator CHAPMAN**—Given your comments to the effect that the current exchange rate and terms of trade are detrimental to domestic manufacturing and the like, do you advocate some sort of protection for those sectors, even if in the short term, or some form of intervention?

**Mr Wadsley**—I would suggest that we need to be looking at the broadest based intervention rather than necessarily supporting car manufacturers at the expense of any other type of manufacturer, because it is an issue if you are looking at cars and saying car manufacturing is particularly special but some other manufacturing is not. Instead, I would suggest that we take the broadest based approach, which is through the exchange rate. We need to look at how we can bring the exchange rate down, and that is by increasing savings—that is, increasing the surplus. That will help manufacturers right across the country, as opposed to looking at one individual sector.

**Senator CHAPMAN**—When you are talking about increasing the surplus, you are talking about the government doing that?

**Mr Wadsley**—I think the government should be taking a view to all three sectors that form our economy: there is the government, there are individuals and there are businesses. Business is obviously doing a lot of investment at the moment and that is part of the reason why the current account has not perhaps turned around—if they were saving more. But I do not think that it would be appropriate for the government to intervene in how businesses choose to invest or save. At the individual level, I think there could be more done in terms of incentives and certainly the government at the level of the terms of trade that we have, which suggest that the budget perhaps should be seriously a bit higher from a macroeconomic and my personal perspective.

**Senator CHAPMAN**—In terms of individuals, we made some changes to superannuation a couple of years ago to provide more incentives to people to save for their retirement through the superannuation structure. Are there any other areas where you think government could provide incentives for individuals to save? We are notoriously low savers as individuals, aren't we, nationally? Are there other incentives that you have in mind that could be provided?

**Mr Wadsley**—My view on superannuation would be that it looks purely at the retirement motive for saving. There are lots of other motives for saving which are almost precluded by the structure of superannuation. You have people saving for investing in a house. You have people saving for adversity or saving to take time off for child-rearing. So there is a question of the extent to which the limitations we are putting on superannuation are making it harder for people to save in other areas and making them feel that it is perhaps not necessary—whereas in other countries which do have higher savings rates on an individual basis, it is often for precautionary purposes. So, in the United States, people will be encouraged to save in case of job loss. That does not seem to be part of the mentality in Australia to actually put aside money for those sorts of unfortunate circumstances. It may be something to do with the level of government intervention, but I think that would be part of a flexibility around superannuation which is not there.

**Senator CHAPMAN**—Do you have any thoughts about what sorts of incentives might work—some sort of tax incentive for saving, as we have with superannuation saving?

**Mr Wadsley**—My view is that we should not be restricting when people can withdraw their superannuation. At the moment, we have this system that we created that encourages people to take all the money out when they reach the threshold, burn it as quickly as possible and then move on to the pension. That is the way the structure works. Your only real incentive to save is in that sort of ramp-up period 10 to 15 years prior to retirement. Before that, there is not much of an incentive to save, assuming that you want flexibility in how you hold your assets, not necessarily locking them away for a small tax benefit. So I would suggest that you would want to say, 'Well, perhaps we need to assume that when you spend or save the money is your choice,' and then encourage people to have more savings in general for all of life's events, and that would assist. Removing some of the constraints associated with withdrawing superannuation would improve flexibility and perhaps allow people to save more at their discretion than they would otherwise, because at the moment they are saying, 'If we put money into superannuation, we cannot get it out again, so what happens if we have another kid; what happens if we have a sudden emergency of some sort?' They could not actually make that allocation because they could not get the money out if they needed it.

**Senator CHAPMAN**—Okay. Thanks.

**Senator BUSHBY**—Continuing with the terms of trade consequences, the last time that we saw terms of trade outcomes like the ones we are currently seeing was in the 1950s and 1970s. They were the two most recent times that we have had similar outcomes. On both those occasions we had rampant inflation. Do you think that the terms of trade that we are experiencing are having any effect on inflationary pressures at the moment?

**Mr Wadsley**—Absolutely.

**Senator BUSHBY**—To what extent? We have heard a lot in the national debate about the inflation challenge, as my side of politics likes to call it, or the cancer eating away at the Australian economy, as the other side calls it. Do you think the terms of trade are a significant part of that challenge?

**Mr Wadsley**—I think they are. The difference between, say, this inflationary episode and, perhaps, inflationary episodes that we have seen in the eighties and so forth is that this one is externally driven. It is external forces which are pushing on the Australian economy, and that is what is ‘letting the genie out of the bottle’, so to speak. So there is a real question there as to whether the monetary policies that the Reserve Bank might choose to use in that event are appropriate, because the models have not necessarily been so calibrated for assuming that it is external.

**Senator BUSHBY**—As I understand it, monetary policy is basically designed to squeeze households just to a sufficient extent that they stop spending because they have no more money to spend, and that then reduces the inflationary impacts on the domestic economy. What would you suggest, then, given that terms of trade, according to our evidence, are the primary driver of the inflation challenge? You talked about Norway and how they have money going out and are saving outside. How could we set something like that up here to reduce inflationary pressures?

**Mr Wadsley**—The structures are already there. The question is: to what extent are we really using those as improvements of the fiscal policy? The fiscal policy has been a tool for resolving the crisis, as opposed to looking purely to monetary policy. So fundamentally there has got to be a larger surplus, and that money has got to be put into overseas structures.

**Senator BUSHBY**—So you think that the government needs to be putting it there. Rather than encouraging individuals to save overseas, the government should be diverting its surpluses that way?

**Mr Wadsley**—The government will generally have a greater power and stretch to do that in a concerted fashion. So, in terms of being able to take that intergenerational view, the government is, perhaps, in a better position to do that than many individuals are. Individuals may not necessarily feel the same way about the events and their own personal future cash flow likelihood to actually be able to make some precautionary saving to the degree required at this point in time.

**Senator BUSHBY**—I have one final question on that before we get onto state finance, which is what we are here for. Do you think that the recent federal government budget, in an economic sense, cut hard enough to actually make a sufficient chunk to send overseas?

**Mr Wadsley**—No.

**Senator BUSHBY**—You talked in your submission about GST. You note there that it has certainly increased the revenue base for the states and that it has provided a degree of certainty for that.

**Mr Wadsley**—Correct.

**Senator BUSHBY**—But you also say that VFI, or vertical fiscal imbalance, is still a problem and that the GST has probably exacerbated that, primarily through loss of flexibility in the ability to raise state own-source taxes. What possible solutions do you see to that? You talk about some in here—I think there are three, mainly—but would you like to just quickly run through those? In the context of that, yesterday we had a recommendation from an economics professor in Victoria that income tax should be removed from the Australian government and that the state governments should be given the freedom to raise that themselves—or that basically they should be encouraged to attempt that; they can now, technically. In the context of your answer, could you address that as well, please.

**Mr Wadsley**—State government revenue at the moment, as I see it, is fairly poorly structured. It is relatively inefficient, and most people are not aware that they are being taxed. We have taxes on transactions in terms of property which are not efficient; we have taxes on gambling; we have payroll taxes. Ten years ago I would have said that payroll taxes are very efficient. Now, given that we are looking at the demographic cusp, we may say that they start looking more efficient. But we have got a state taxation base which does not encourage responsibility on the part of the state governments raising it, because most people are not aware of what they are paying in tax. So there is that sort of ‘taxation without representation’ aspect. Then there are a lot of procyclical aspects in terms of, particularly, stamp duty—or duty, as it is now called. Floods of revenue come in during a boom, and we have to wonder whether those revenues will be maintained if we have a downturn in housing, which is obviously likely, given the monetary policy stance.

In terms of a personal view about how they should be shifting, I am aware of a proposal by Graeme Wells, at our school—and I would certainly support it—which basically broadens the view of land taxation to make it a stable annual charge and moves away from the situation where there are exemptions for householders but where landholders who rent out their property have to pay a tax which owner-occupiers do not pay, which creates a discrepancy which ends up being paid by renters in higher rents. Instead, we should simply be looking at a broad based annual charge for a property, which will then encourage the most efficient use of that property. If that is a tax that everybody is aware of, they will then expect higher accountability from their state governments on how that money is spent, rather than having a whole lot of duties which people may be only paying in a few times in their lifetime which they are not really focusing on. But at the same time it is actually increasing the cost of housing and the efficiency with which we allocate our housing stock.

In terms of income tax, perhaps there is merit in allowing a swing threshold that would suggest that some state governments charge a few per cent more in order to pay for additional services, if they think it is required. That would be a fairly democratic way of letting people know what their governments are doing and how they are managing their balances. I suspect that even if state governments had the option—and they always do have an option—they would never politically choose to take that option. But it would certainly be putting it on the table so that, if they are unhappy with the way things are operating, then they have that solution.

The other major area to look at is to what extent will states more effectively user pay—user pay is now a dirty word—the services they provide. There is a lot of service provision that is happening which people could take more responsibility for in terms of their own revenue, rather than having it pooled. Look at HECS: it is a very effective mechanism for bringing together people's choice to take on tertiary education and their ability to pay for it later in life. The government have an excellent source of liquidity in that they can provide money at one point in somebody's lifetime and then collect it back at another point in their lifetime. That liquidity service would probably address some of the major issues that we have in health care, where the main reason people need to have insurance is that, while in their lifetime they will certainly have enough money to pay for their health care, they never do on any individual week or month when something might go wrong. If the government is willing to provide a liquidity to people to pay for their own health care, where that is required, then they can repay that using efficient tax.

So the tax is a very efficient way of collecting payments and doing so progressively. Perhaps we could make it that much more surgery was available and the government would loan you the money and then it could be paid back using a HECS style system. By doing that we could ensure that the government is not under pressure fiscally in terms of its bottom line, but it is still using its balance sheet to enable everybody to get health care when they need it. If you look at some of the stress in the private healthcare sector at the moment, that would certainly be a structure that could resolve that issue.

**Senator FORSHAW**—Mr Wadsley, thank you for your interesting and intriguing submission. I am still trying to come to grips with some of it. Firstly, why is it called dutch disease?

**Mr Wadsley**—It is called dutch disease because it was first identified in the Netherlands in the 1980s, when they had all the oil and gas revenue coming in from the North Sea. Holland had previously been placed fantastically in Europe, near Germany and Belgium—the industrial heartland. Rotterdam is one of the most active ports in the world. They had a very strong manufacturing sector and suddenly, because oil and gas revenues were coming in, they asked why it was that their manufacturers could no longer compete. Why were so many of their manufacturing industries shutting down? This raised the question: what is the relationship between the terms of trade and the export sectors?

**Senator FORSHAW**—You mentioned in your submission, and again in your evidence this morning, that you used Norway and Chile as a reference point for comparison. I think I understand what you are getting at there, but one of the differences is the different government structure in this country, compared to Norway and Chile. We have states which have large economies.

How does that impact upon what you are saying? When we measure terms of trade and we look at that, we look across the country as a whole. But clearly part of the focus of this inquiry is what is happening at the state level in comparison between the states, as well as with the Commonwealth and also federalism and how we give better efficiency and cooperation. Does it make a big difference that we have a federal structure like ours rather than a structure like Chile, which I do not think is really a federal structure, or Norway, about which I am not quite sure but I doubt it?

**Mr Wadsley**—What the federal structure allows us to do is to examine at a more local level how these different forces are playing out. So we can see that Western Australia and Queensland are going through the boom. The Northern Territory is as well. And we can see that Western Sydney and Victoria and Adelaide manufacturing sectors are doing it very hard. So what it allows you to do—while theory is saying that we assume that we have two goods: exportable goods and non-tradeable goods—is to look at it in a more geographical sense and say that we have exporting states and manufacturing states. Therefore, we can see that the forces that we think we have identified are playing out as we would expect them to.

From a policy perspective, the issue is to what extent a federal government collects as much of the excess rent that comes from these high mineral prices and is able to allocate them to the best purposes of the nation or whether states are getting that cash and making a reinvestment in their own state economy. So if Western Australia is taking additional revenue from, say, the north-west shelf and then reinvesting that in the Western Australian economy, we really have an exacerbation of these external effects, because they are trying to spend the money in this generation, whereas if you have a broader base to collection of resources of rent revenue and then that can be allocated overseas or to those states that are not doing so well, that would then allow you to get a more balanced economic outcome. So there certainly will be some federal-state impacts in terms of how revenue is collected.

**Senator FORSHAW**—What do you think should then happen with the differences in taxes that are applied by the states—different levels of payroll tax and different systems of workers compensation and land investment taxes and so on?

**Mr Wadsley**—I think, in general, one would be—

**Senator FORSHAW**—What is often pointed out is the competition between the states. That between Queensland and New South Wales is the one that I am familiar with, because I am from Sydney.

**Mr Wadsley**—Competitive federalism certainly has merit in terms of an argument to find out what the best system is and then allow different systems to compete. I think there is a question in terms of having competitive federalism at one level, where we design to encourage states to compete with each other to minimise their tax levels and deliver better services, and then we have horizontal fiscal equalisation—robbing Peter to pay Paul and creating a merry-go-round as to how they manage their funds. There are some areas where you get artificial cost shifting—this idea of stamp duties and so forth, where people are stamping documents in Canberra to minimise the duties they pay. That sort of competition is—

**Senator FORSHAW**—Those things are important, aren't they? We hear a lot about the resources boom—there was what you said about Western Australia and Queensland particularly. But, for instance, a couple of years ago a lot of the focus in New South Wales, for example, was on property. That was supposedly a big windfall from the state government, but there have been significantly increasing property prices within the Sydney market.

I suppose what I am trying to tease out here is this: do you think that as far as possible you should have some sort of consistency or uniformity in regard to tax rates and application across the various states in those traditional areas? The gambling tax is a large component of the New South Wales budget. But it has a particular situation. It has had a much bigger club industry and hotel sector than other states.

**Mr Wadsley**—In general, I would suggest not, in as much as competitive federalism is a good model. We can use the federal structure that we have to drive long run economic efficiency. There are some areas where the tax base should be federal, because that allows for a more efficient way of doing things. Corporate style taxes probably fit in there. Companies are taxed federally. That is probably more efficient. One would have to say that stamp duties on financial transactions would probably fit under the same sort of model, because the game that is being played is not necessarily efficient. At another level, I would suggest that the resource taxes should probably be federal in nature as opposed to state in nature. The recent change with respect to condensate on the North-West Shelf is probably a step in the right direction from that perspective in terms of that North-West Shelf anomaly.

**Senator FORSHAW**—One final question. The thing that sort of jumps out at me from your submission—and I appreciate that this is all related to a PhD thesis, and obviously it is a huge research exercise in that respect—is that you refer to Newcastle. I read it as if you are saying that the worst possible thing you can do in a port like Newcastle, which has 40 or 50 ships parked outside trying to get in—more when a storm comes—is plough a lot of state money, or any money, into expanding that port or whatever. I understand your argument—it creates more activity, which creates more bottlenecks. But it is hard, I suppose, to accept it, because what you have is the industry and the state and everyone else saying, 'This is costing lots of money, because ships are staying idle because they cannot in and out of the port and cannot load and unload, and productivity is going to be improved if we can do that quicker, and the only way that you can do it quicker is to expand.' Not that Newcastle should end up like Rotterdam; I have been to Rotterdam, and it is enormous. It is the biggest port in the world, or the one with the most activity. That is the bit that I, and I think everybody will, have difficulty with.

**Mr Wadsley**—It is counterintuitive. That is absolutely right.

**Senator FORSHAW**—But isn't it relevant that you have to find a mechanism to reduce costs and increase efficiency and thereby productivity ultimately with the existing level of activity without having to think about a bigger port that more ships can come in and out of—simply making it all work faster?

**Mr Wadsley**—The question I would ask is this: where is the additional money that comes from loading additional ships with coal going to go? If it is going to go back into the Australian economy, then we are simply fuelling the inflationary bonfire. If one is going to say, 'We're going to invest in ports'—

**Senator FORSHAW**—Sorry to interrupt, but some might say that the costs associated with having labour or machinery or whatever lying idle for a week rather than a day fuels inflation. This was the argument about the waterfront. How do you improve loading and unloading rates and so on to ultimately reduce cost?

**Mr Wadsley**—Under different terms and in a different time in the cycle, one would say that we must improve the productivity of our export sector, because lack of productivity is reducing the exchange rate too much, which is reducing our ability to borrow overseas. Therefore, the lack of productivity in the export sector is the problem. Currently, because we have high terms of trade, that complements productivity to such a great extent that from a macroeconomic level it does not make any difference.

I can agree from an asset management perspective that, yes, they should be looking at improving productivity because they are working for their shareholders. But, from a macroeconomic management perspective, if we were attempting to address the problems with a national perspective, we would be saying, ‘If we’re going to increase coal exports then we’ve got make sure we’re actually putting that money somewhere where it’s not going to do more harm than good.’

**Senator FORSHAW**—I understand where you are coming from, I suppose. So it is very much related to how the terms of trade are to a point of time and including the value of the dollar.

**Mr Wadsley**—Yes.

**Senator FORSHAW**—But I suppose the other point that industry and governments would argue is that it is important in relation to the concept of a reliable supplier, because, if you can demonstrate that you are more productive or more efficient, that is going to help you to win further business. In the long term it has that benefit at least.

**Mr Wadsley**—And I think there is a lot of that business style argument.

**Senator FORSHAW**—Particularly in an increasingly competitive world with exports.

**Mr Wadsley**—The question in terms of the terms of trade would suggest that we are not in a particularly competitive world because demand is in excess of supply and therefore we are in an excellent position, and that is why there are 50 ships lined up off Newcastle. The issues raised are very hard. That is moving to that sort of private sector decision making. So the question is: is the state government acting as a private investor or is it acting as a public macroeconomic manager?

**CHAIR**—Your theses will benefit from input from Senator Forshaw, which was to be my input, I have to say, Senator Forshaw.

**Senator FORSHAW**—I’m not sure if I would!

**CHAIR**—I say that in a slightly tongue-in-cheek way.

**Senator FORSHAW**—Thank you!

**CHAIR**—But it was my point, too, coming from Queensland. I fly over Hay Point and Dalrymple Point every time I come to Canberra and I see massive ships out there at enormous expense waiting around for coal—which is there and can be easily accessed, but you cannot get it through the port and you cannot earn all that extra money for Australia. I guess you are saying, Mr Wadsley, that earning the extra money is inflationary.

**Mr Wadsley**—Earning the extra money and trying to pour it into the economy now will be inflationary. Earning the extra money and saving it overseas, in the way Saudi, Kuwait and Chile have done, will not be.

**CHAIR**—When you say ‘saving it overseas’, what do you mean?

**Mr Wadsley**—Creating sovereign wealth funds and investing in assets offshore. In that way we would avoid the pressure that would come from those dollars entering the economy instead of being saved for a rainy day. If the money comes here, we will bid up the costs of goods and services here and we will actually get no real benefit from it.

**CHAIR**—It is certainly, as you said, counterintuitive. Thanks very much, Dr Wadsley. That has been very interesting. We have gone over our time, but thanks for your time.

**Proceedings suspended from 11.28 am to 11.39 am**

**HODGMAN, Mr William Felix, Leader, Liberal Party of Australia, Tasmanian Division**

**CHAIR**—I indicate to Mr Wadsley, who is still here, that there were some questions we intended to ask you about super in Tasmania. Perhaps if you could drop us a note on that later. I thank the Hon. Will Hodgman, the Tasmanian opposition leader, for being with us today. I understand you have rushed back from overseas especially to talk to us. Thank you very much for your submission. I thought it was very comprehensive, mature and well-thought through. I invite you to make an opening statement and then subject yourself to the questioning of the committee! I am conscious that you need to get away by 12, so all of us will have to be very brief in our questioning.

**Mr Hodgman**—Thank you for the opportunity to present to you today. I do so on behalf of the state opposition and I do so by giving a preliminary rider to the submission, which was prepared by the state opposition, that I am no financial expert. I will certainly endeavour to answer any questions you have and, if I am not able to, I welcome the opportunity to provide additional information by further written submission or any explanatory notes as appropriate.

I might provide some context as well. While I have been keen to ensure that our submission remains relatively benign politically, obviously a lot of what we say comes from the context of political concerns. A lot of the submission is self-explanatory, so I will not detail more of the obvious matters which will no doubt be familiar to you by now. I will, however, highlight a couple of key aspects. Firstly, the state government's revenue is obviously predominantly funded or sourced from GST with about 64 per cent of total revenue, and 44 per cent of that being derived by the GST, with state taxes making up only 20 per cent of total revenue. That is obviously a subject of interest and also, in some respects, a concern.

The state opposition has advocated a comprehensive review of our state based taxation arrangements. I note that the Prime Minister has committed to undertaking a similar thing at a federal level. We believe it should happen in Tasmania as well. The purpose of such a review would be facilitated by a summit which engages business, academia and the broader community. That would ensure that our state based taxation system is as efficient and as equitable as it can be, and that it is best placed to address challenges in this state, such as learning, demographic change issues and ensuring that the balance is remediated a bit to allow Tasmania to be more sustainable in so far as its revenues are concerned. The state opposition has proposed a tax summit to identify opportunities for tax reform that would have the impact of improving long-running economic growth and equity.

We have taken the liberty of including in our submission a number of observations and representations that have been made to our office by constituents and stakeholder groups with respect to some state taxes and duties. Since our call for a review of our state taxation arrangements we have received many representations. Indeed, in parliament, as the shadow Treasurer I have also raised issues on behalf of constituents with respect to our tax arrangements and the impacts on people and businesses in this state. For example, just last month I again raised the issue of land tax in this state. In one particular case there was an astronomical hike in the land tax rate applied to a local business. I believe there is a misconception that people who pay land tax bills are wealthy landowners, but many people have invested in property as an

alternative means of superannuation. Many people are now feeling the pinch with the increased cost of living, increased interest rates, increased petrol prices and so on, and they are now faced with astronomical hikes in land tax bills. The government's typical response is to say that this is a by-product of rises in land valuations, and to an extent that is true. They also often say that the increase in land tax is proportional to those increased land valuations. But, whilst there is certainly a correlation, it does not stand that that is necessarily a result of a proportion of increase.

In fact, I mentioned the case of a business proprietor of a shopping centre on the east coast at St Helens. Information provided to me by that proprietor was that in the financial year 2006-07 and then 2007-08 his property received an increased valuation of 180.69 per cent, but the actual increase in his land tax bill was 507 per cent. So, while the adjusted land valuation of his property had gone up by 180 per cent, the land tax bill went up by 507 per cent. In that case it meant an \$18,000 land tax increase. Notwithstanding the success of this particular business operation, the St Helens central shopping complex, it was a major increase in their land tax bill. There is obviously an issue there that needs further investigation, to see whether it is the most efficient and equitable tax system, because it would appear from these cases that we have received notice of that there are some issues there that need further inquiry.

Other concerns have been raised with us by constituents and stakeholder groups with respect to payroll tax, duties on conveyancing, gambling taxes and the controversial and poorly implemented plan by the state government to introduce an ambulance levy—which is a classic case of a dog's breakfast brand policy on the run. If anyone has concerns about this government's capacity to properly implement fiscal policy in a considered and well-consulted way, then they need only look at the ambulance tax fiasco as an example of an abject failure. Just recently the Treasurer announced that a levy will not be introduced in this financial year, notwithstanding their commitment to do so, but will be deferred to the next financial year. That is obviously an issue of considerable interest to the Tasmanian community as they contemplate having to pay to use an ambulance in this state, notwithstanding the fact that the government, prior to the last state election, said that it was opposed to such a tax: it was not necessary in Tasmania.

The state opposition have, as part of our fiscal policy agenda, also proposed investigation into the establishment of a Tasmanian future fund, as referred to in our submission. I just want to briefly outline the context of it as it not only provides a major aspect of our submission but also relates specifically to the Superannuation Provision Account and also to a number of the terms of reference of this inquiry, particularly in relation to investing in our infrastructure for the future. We firmly argued that the state's finances should be measured with great care and accountability and with pressing challenges, such as those presented by demographic change, where we will see Tasmania's working-age population decline. This will in turn place significant pressure on not only economic growth but our capacity to generate revenues under our state tax base and to access GST revenues, coupled with a historic underinvestment in infrastructure in this state.

We believe a future fund could be established that could be constructed initially from the sale or transfer of liabilities and assets to the Superannuation Provision Account, then built further by allocations from the consolidated fund, dividends from existing government business enterprises, asset transfers and proceeds from sales of assets such as those that the government has planned and announced. Not only would this protect funds in the Superannuation Provision Account from

being misinvested; it would also make transparent the lie that is the government's claim that it has no debt, when it does in fact owe, I believe from recollection, in excess of about \$0.5 billion to the Superannuation Provision Account, which is already an unfunded liability in excess of \$2 billion. Also the Tasmanian future fund would better provide for funds into the future to attend to the infrastructure needs to address the challenges of demographic change and to provide a more sustainable base for funding those challenges.

Finally, I just want to make the point in relation to the recently released midyear financial report that the capacity of the Tasmanian government to better invest in infrastructure exists. The Tasmanian government has been reported by independent experts as having underinvested in infrastructure in this state, which is, of course, a constraint to economic and social development. The state opposition also believes that investment in infrastructure should be met by all levels of government. It should not just fall to a state government. Where appropriate and possible it should also be with the assistance or contributions from the private sector. There is a greater capacity now, with the revised financial statements released by the government, for the state to better invest. The recent announcements from the federal budget will also enable Tasmania to become more sustainable in the long term. It is a policy priority of the state opposition to invest heavily in our infrastructure to achieve those objectives.

I will leave it at that and I am happy to answer any questions or provide any information. If I am not able to do so at this point, I would welcome the opportunity to make a further submission or obtain information that is necessary. Thank you for this opportunity.

**Senator CHAPMAN**—Some of the evidence we have heard in other states, particularly from opposition representatives, is the issue of what they regard as a misallocation—'misdescription' is perhaps a better term—of the way in which funds are used between recurrent expenditure and capital expenditure. The claim is that a number of items of expenditure, such as maintenance in schools, are being described as capital when they are truly recurrent expenditure. I asked the Auditor-General earlier about this and he said that he would be able to pick that up in the accounts and that he was not aware of it happening in Tasmania. I wonder what your view is of the extent to which that is or is not happening.

**Mr Hodgman**—There has been some debate on that issue in estimates hearings and the like. I do not believe it has been recorded as a substantive concern, considering the reports and observations of the Auditor-General and, indeed, other financial commentators. But there has been some commentary over the description that is applied to recurrent expenditures. It would appear that there has been some inconsistency in recent years, as we move to more modernised reporting procedures and systems. From my perspective, there has been some confusion as to this issue, and the government have, to be fair, taken some steps in recent times to make their budgeting financial statements more transparent and accountable. But I think there is still a degree of work to do.

**Senator CHAPMAN**—I take it from your submission that your argument is that, although revenue has been increasing significantly, the state government's net financial position has actually deteriorated.

**Mr Hodgman**—Yes, but we have, as I said towards the end of my opening statement, a revised financial position which does appear to provide greater capacity for the government to

invest where it had been reporting deficits into the foreseeable future. That position has now altered.

**Senator CHAPMAN**—Given the increase in revenue over the last few years, where has the money gone? If up until now it has not gone into some of the projects that you regard as being essential, what have they done with the money?

**Mr Hodgman**—That is a good question. One of our primary criticisms of this government is its investment in projects which we say are perhaps inappropriately given priority over areas which we consider fundamental to ensuring that the state's prosperity is not only enhanced but capitalised. We have been very critical of this government's misapplication of funding. We are anxious about the government's capacity to achieve outcomes. You need only look at the performance of our health system or education system to see that we are underperforming against national benchmarks. For the government to assert, as it does, that it has made major investments—record levels of investments—in those areas but to have not achieved a correlated improvement in the outcomes is a major concern to us as the state opposition.

**Senator CHAPMAN**—Yesterday, we had evidence in Melbourne from the Institute of Public Affairs, who argued that rather than pushing revenue and responsibilities upwards they should, in fact, be pushed downwards. They were advocating returning income-taxing powers to the states and devolving clear responsibility for things like hospitals and education to the states rather than having the duplication and overlap. I wonder what your view might be of that.

**Mr Hodgman**—It is certainly not our party policy for that to occur, but we would welcome any debate that provides greater transparency and accountability to all states and territories to lift their levels of output and achievement with respect to output. But it is not our policy to make Tasmania an income taxer.

**CHAIR**—I do not want to interrupt you, but I am conscious that Mr Hodgman wants to leave by a certain time.

**Senator CHAPMAN**—I am finished.

**Senator FORSHAW**—I should indicate, Mr Hodgman, that I did ask the Auditor-General, who was the first witness this morning, if he would read your submission and respond to us on some of those assertions which go to how things are described, particularly in relation to the superannuation situation and also to off-balance-sheet finance in the state owned corporations. You make the comment in your statement that 64 per cent of total revenue comes from federal sources, of which the overwhelming proportion is GST. I note you have proposed a tax review. I am wondering whether you think there is a lot of scope for shifting the balance to more revenue being raised from sources other than federal ones. A substantial proportion of the state's revenue is coming from federal sources and you have listed a number of state taxes but they are all fairly small contributors, so I am trying to get some idea of where you could move to. I am not trying to second-guess what might come out of your review, but there does not appear to be much scope and therefore you have that constraint on the Tasmanian state economy or state government of being heavily dependent on the federal government sources.

**Mr Hodgman**—I think you are right, and I am not arguing against the federal government making such provision to Tasmania.

**Senator FORSHAW**—You are not arguing for any new taxes, obviously.

**Mr Hodgman**—No.

**Senator FORSHAW**—That is what leads me to wonder about how you review the state tax system.

**Mr Hodgman**—That is right. The primary concern we have is about ensuring that our state based taxation system is equitable and as efficient as it can be. We do not believe it is. We also want to ensure that there is an environment in Tasmania which will be attractive to investors, to businesses and, indeed, to people so they will move to Tasmania and make it their home. We want to make sure that we are as competitive as we can be to provide us with the best opportunity for that to occur. Again, we in the state opposition are not convinced that is the case. Whether or not we can significantly alter the balance to any great extent is not part of our argument, but it does concern some financial commentators and it does interest us at a political level that Tasmania's long-term financial independence is a little more precarious than is the situation in other states, which obviously have far greater revenue-raising capacity. Part of my vision for the state is to ensure that Tasmania is as efficient and competitive as it can be and that this is as sustainable as it can be to provide a bit more of a buffer so that we are not as reliant on federal government sources.

**Senator FORSHAW**—And it stands to reason that if you can get more economic activity within the state then GST revenue should rise in dollar terms at least, though not necessarily in percentage terms. Do you believe Tasmania is getting a fair deal out of Commonwealth-state financial relations at the moment?

**Mr Hodgman**—Yes—

**Senator FORSHAW**—I come from New South Wales—

**Mr Hodgman**—I know.

**CHAIR**—So you ought to start off by thanking Senator Forshaw for contributing!

**Senator FORSHAW**—Well, it has been said by your leaders in the past as well as mine! I am just interested in where you think Tasmania sits.

**Mr Hodgman**—I think, by and large, we are getting what we deserve. I would certainly fight for as much of a share as we can, as indeed the Premier—

**Senator FORSHAW**—There are no stand-out anomalies that you see with regard to Tasmania?

**Mr Hodgman**—No. I will just make the point also that a large part of the concern that is generated for the state opposition, as indeed it would be for the state government, is the current

demographic issues that we have. You may be familiar with them or have heard of them, and the government has currently got a council that is looking into the challenge because we do have population issues. We continue to suffer an exodus of young, innovative, creative, productive people from the state which is going to impact on our capacity to raise state based revenues. It will to some degree also impact on our GST situation. Tasmania needs to remediate that. So that is a primary focus for us as the opposition and also a large part of our concern to make sure that Tasmania can be as competitive as it is and that it does attract business and investment here in a greater way than is currently the case. No, we do not argue that Tasmania is being reasonably favoured by the current arrangements.

**Senator FORSHAW**—Or unreasonably.

**Mr Hodgman**—Or unreasonably. It is probably about right. The state government has now almost fulfilled all its obligations under the GST agreement, which is good because one of the arguments has been that, until such time as they did undertake those reforms, the agreement was unfairly skewed. But they have complied, as far as I am aware, to the full extent of that agreement.

**Senator FORSHAW**—Thank you.

**Senator BUSHBY**—Thank you, Mr Hodgman, for what I think is a very comprehensive submission that contains a lot of things I would love to explore if we had more time, but we do not, so I will just focus on a couple of things. We have heard that, in common with other states, the revenue of the Tasmanian government sector has risen enormously over the past 10 years and expenditure has risen to at least match it. In New South Wales in 1995, I think it was when Bob Carr was first elected, he enacted legislation which required the government basically to store surpluses away in good times to ensure that, when times were not so good, the government continued to deliver the services that needed to be served without any interruption caused by lower revenues from taxation. Given the good times that the Tasmanian state government has faced in recent years, has it used the increased revenues to invest for the future or to put dollars aside to ensure that the delivery of services is not interrupted in any shape or form?

**Mr Hodgman**—Our argument would be clearly no, and the results reflect that underinvestment, and that is exactly why we propose a Tasmanian future fund. We believe that it should have happened years ago. It will remain our policy that one be established to ensure that during good economic times, such as those which we have experienced in recent years, there is greater provision for longer term investment. We would rather the government look to a longer term fiscal strategy than to short-term political imperatives, as is the case now. And that vehicle, the future fund, provides not only for investment for the long term but also greater returns for government. Those moneys can be better utilised to obtain a far more impressive return than is currently the case.

**Senator BUSHBY**—It is my own personal recollection—so I am interested in your evidence on this, although the Auditor-General did confirm it—that, at least in part, the considerable debt that the Tasmanian state government had in the late 1990s was paid off with the assistance of dividends that it took from government business enterprises, and it was actually quite a clear policy of the then Treasurer, David Crean, to withdraw money from the Hydro to help pay off the debt. Do you have any recollection or knowledge of how those dividends were calculated?

On what basis did they actually decide how much to take from the government business enterprises?

**Mr Hodgman**—Firstly, I will make the comment that obviously we are not opposed to the government deriving benefits and dividends from state owned or government business enterprises; it is highly appropriate. The Hydro is a classic illustration, though, of where a special dividend was taken over a number of years which compounded that entity's fiscal situation to such an extent that Dr Crean, I think, or perhaps the CEO of the organisation conceded that the Hydro's balance sheet was stretched and stressed, and there is continuing public concern about that entity's financial situation. The government has indeed undertaken a review or has obtained expert independent advice to make an assessment and to audit aspects of the corporation's financial position. I cannot provide you with the historical account as to how those dividends were determined or calculated, but it would certainly appear that the government took dividends to such an extent that it compounded the financial distress of that corporation, and it has now resulted in a situation which, as I said, has been described as being stressed and stretched.

**Senator BUSHBY**—Media reports in the last couple of days in Tasmania have suggested that the Hydro has requested between \$300 million and \$450 million from the state government to improve its finances and so that it can remain competitive in the national electricity market. Do you think that those special dividends have contributed to the need for the Hydro to go to the government and ask for that sort of money?

**Mr Hodgman**—Yes. There is almost a direct correlation. Admittedly it would be cute of me to suggest that it is as simplistic as this, but that amount does relate to the amount that was taken via special dividends over that period—from a time when, ironically, Dr Crean was Treasurer of the state. He now finds himself at the helm of Hydro Tasmania trying to remediate their financial woes. But, as I say, it is an issue of ongoing concern to Tasmanians, and obviously we will be keen to get a little more information from the government to ascertain the precise condition of Hydro Tasmania's woes.

**Senator BUSHBY**—Your submission discussed—and you also mentioned—the issue of the unfunded superannuation. The Auditor-General this morning acknowledged that the negative debt of \$409 million—or the surplus of \$409 million showing up in the last audited accounts—does not include provision for the \$1.17 billion of unfunded superannuation, although it is accounted separately in the papers as a liability. It also does not include the billions owed by the GBEs, which the Auditor-General says is not accounted for in the government papers. Would you care to comment on what your thoughts are about the actual net debt situation of the state government?

**CHAIR**—Just before you do that—I wrote down \$3.67 billion for the unfunded superannuation.

**Senator BUSHBY**—I think that that is the total projected estimation, but the \$1.17 billion is what is showing on the accounts. You may need to get somebody else to explain that in detail, but that is all right for the bits of paper.

**Mr Hodgman**—Yes, that is right. I referred in my opening statement, and also in my submission, to the fact that there is a perpetuated myth that the government is net debt free. But, with those off-balance-sheet liabilities, we mount the argument that that is not the case. Whilst that may not necessarily present a problem in fiscal terms, it does in terms of perception and fiscal transparency. We have had ongoing discussions with the Treasurer and, indeed, the secretary of the department, as you will see from my submission, as to how those figures are properly presented in a way that is not as confusing and that can provide the public with greater understanding and appreciation of the state's fiscal situation.

**Senator BUSHBY**—I have one final question. In your submission you talk about the blame game, and you throw up a few examples of where that has occurred. One that I am particularly interested in is the Bridgewater Bridge. Would you like to inform the committee about what has happened there, the history of that and how you see that fitting into the issue of federal-state financial relations?

**Mr Hodgman**—Yes. I highlighted a couple of more recent examples, not to make gratuitous political points but rather to identify issues. I guess it does tie in with what Senator Forshaw was asking in relation to federal government contribution to our infrastructure needs. The Bridgewater Bridge impasse, or the inaction on progressing what is a major infrastructure issue for this state, has been most regrettable. There was a previous commitment by the former federal government to provide \$100 million. In fact, I think it went back as far as 2004 or 2005. The not uncommon political impasse that can result between state and federal governments meant that that project was never commenced.

**Senator BUSHBY**—It required \$100 million?

**Mr Hodgman**—Yes, which for Tasmania—or, indeed, any jurisdiction—is a major contribution from the federal government and not one which we were going to argue with. But unfortunately, due to politicking, there was nothing done on that. There has now been, obviously, water under the bridge, and a different plan is now in place, which we are highly supportive of because it is one of those infrastructure projects that we believe are necessary to make Tasmania more competitive, to improve our transport and freight task and to make Tasmania more efficient. The fact that it did not happen and that \$100 million has effectively gone to waste is extremely regrettable.

**Senator KIRK**—Thank you for your submission, Mr Hodgman. The funding that you have just been describing has not been removed by this federal government yet. Is that right? You say it is in danger of being axed, but there has been no decision yet.

**Mr Hodgman**—We are not sure precisely what the federal government's commitment is. As I said, it would be inappropriate for me to make light of the fact that the new federal government has made a substantive commitment to our infrastructure task as well, which we do welcome. But, looking historically at that illustration, it was regrettable, I guess, that an opportunity to invest \$100 million in an infrastructure need in this state was not taken on. A number of years have now passed and there has been further delay and an opportunity missed.

**Senator KIRK**—I want to ask you about the Tasmanian Future Fund. What has been the attitude of the government to your proposal to establish such a fund?

**Mr Hodgman**—Initially dismissive because, I assume, it was not their idea. Originally, the Treasurer was quite unaccepting of its merits. I have had more recent discussions with him in a formal sense. Having some insight into the department's frame of mind, I believe that they might now be more receptive to the notion. Indeed, the recent announcement on how the new Royal Hobart Hospital might be funded would suggest that the government is more prepared to look at investing its moneys in a way that it can achieve a better financial return. I must say that the proposal was met with support from financial commentators, more importantly, who are removed from the political arena. The Tasmanian Future Fund was indeed supported in principle as being something worthy of consideration and not something that should be dismissed.

**CHAIR**—Mr Hodgman, you mentioned the ambulance levy in your submission. How has the revenue that was going to be taken from that been replaced, or are you awaiting the budget to see what happens with that?

**Mr Hodgman**—The levy has now been deferred to the next financial year. It is our view, and I think the public records show, that the announcement which was made by the government last financial year as a commitment to introduce the levy in this financial year was done in haste, without proper consideration of the ramifications of that, without consultation not just with the Tasmanian public but with key stakeholder groups who would be directly impacted by such a levy—insurers and so on. It has all got too hard for the government, so the whole thing has been deferred.

What was of concern to us was not only the fact that our ambulance service is being underfunded to such an extent that it needs to be propped up by an additional levy but also the failure of the government to commit to using all moneys received from the levy to properly fund our ambulance service. They could not give us that commitment. The minister, in parliament, could not say that those moneys would be used solely to support our ambulance service. So that was of concern to us as well.

**CHAIR**—Thanks very much. We have taken you over your allotted time, for which I apologise.

**Mr Hodgman**—That is all right.

**CHAIR**—Thanks very much for coming and for giving us your time, and thank you for your submission.

**Mr Hodgman**—Thank you. Thanks for the opportunity. I appreciate it. Enjoy the rest of your time in this fine state.

**CHAIR**—Thank you.

[12.04 pm]

**ECCLESTON, Dr Richard, Senior Lecturer, School of Government, University of Tasmania**

**CHAIR**—Dr Eccleston, thanks very much for coming along and for your submission. I found it very interesting, having floated a couple of ideas which we would be interested in following up. You are aware that these are public proceedings and that this is a proceeding of the federal parliament and is protected by parliamentary privilege. If there is any evidence that you wish to give in camera then you should mention that to us. I invite you to make a short opening statement if you wish. Then we will ask you some questions.

**Dr Eccleston**—As with most university employees, I speak in my capacity as an individual academic rather than on behalf of the department or the university. Thanks for your invitation to appear before the committee today. As you have probably gathered, if you have had a chance to look at my submission, I am not particularly sanguine about the structural pressures facing state public finances. That is largely a product of intergovernmental financial relations in Australia. To an extent that has partially been obscured by good economic times—strong economic and revenue growth over the last seven or eight years. Looking forward, pressures confronting the states—and particularly the non-resource rich states—are likely to intensify. We need to have this debate about state public finances and the sustainability of intergovernmental financial relations. This is not my particular area of expertise, but I can talk about that in a minute.

One of the reasons why I started thinking about these issues is that the structural nature of financial relationships between the Commonwealth and the states underpin much more broadly the issues of how federalism functions—its efficacy and the prospects for reform. One argument that I hope became relatively clear from the submission is that as long as the states are financially dependent on the Commonwealth then the prospects for cooperative or collaborative federalism and relations between the states under the auspices of COAG under any of the other institutions that are rapidly evolving at the moment are probably limited, irrespective of the partisan compositions of states and the Commonwealth. As long as there is that dependence, there is a problem of accountability, blame shifting, cost shifting and so on. Obviously, your discussions and hearings around the country have given some evidence of that.

My broad area of expertise recently has been in comparative and international taxation. Having said that, early in the decade I did a major study on the politics of the GST and its introduction in Australia, so I am certainly aware of these issues. I apologise for not narrowly conforming with your terms of reference. What I thought I would do is provide a broad aggregate picture of trends in terms of intergovernmental financial relations in Australia and where I see them going, along with some of the structural challenges confronting them. What I do know from my comparative and international research are the broad trends in terms of tax policy, both within federal states and unitary countries—which tax systems work and what the main trends are. That illuminates some of my analysis.

At this stage, do you want me to very briefly go through some of the evidence in terms of what I see as being some of the broad trends in state public finances since the introduction of the

GST and the intergovernmental agreements in 1999 and 2000, and where I see the problems lying for state public finances? In terms of policy ideas, I am sure we can leave that to discussion.

**CHAIR**—I am interested in your conclusions on the health system. What we might do is go to questions and then you can go through what we have not taken up. I will start with a biographical note. You are working on a major project involving the role of the OECD in international tax regulation. This is not quite within our terms of reference, but I am curious as to your research there. How relevant are international experiences to the Australian context? I notice that you refer to them in your submission.

**Dr Eccleston**—Very much so. As you are aware, in the instance of competitive pressures confronting the state and national economies, we cannot make economic and tax policy in isolation. Beyond that, the OECD is a key actor in terms of tax policy formation and the dissemination of ideas. So from a political science perspective, who the actors are and who they engage with within particular jurisdictions—political leaders, bureaucrats—and so on is very important in terms of the transmission of policy ideas. I guess I came to thinking about international institutions and organisations from study for the GST. Despite the obvious political controversy and politicisation of the issue, why is it that all advanced industrial economies are trying to pursue a common agenda? It is partly for efficiency and because of the economic merits of the tax, but it is also about this broader exchange of ideas and the role of institutions in that. Secondly, in terms of tax competition and dealing with the challenges of international tax competition, particularly in corporate and capital taxation, the OECD is playing an important and rapidly evolving role in mediating where there are tensions between countries. So that is what that project is all about.

**CHAIR**—Could you just elaborate on your quite thought-provoking but very topical suggestion that, as I understand it, in brief, if the state governments do not reform the public health system and public hospitals, public hospitals should be taken over by the federal government. You then—perhaps you can roll this into one answer; this would have been the follow-up question—say:

...while centralised control of public hospitals would clearly offend the principle of subsidiarity and its normative commitment to decentralisation, in other important respects such a proposal has considerable merit.

That was not quite the quote that I wanted to give you, but it is somewhere. My question is: if the Commonwealth, the central government, were to take over the health system and the hospitals, would your concerns be met by having local boards dealing almost with the non-financial aspects of running hospitals?

**Dr Eccleston**—I guess this is why it is a problematic example. My interest in the hospital funding debate is specifically from a public finance perspective and, to the extent that it is possible, I think we need to put governance issues to one side. I used the funding of public hospitals as an example just to illustrate the expenditure pressures that state governments are under. The simple fact is that not only does Australia have the highest vertical fiscal imbalance of any advanced industrial economy but the states are constitutionally responsible for providing health and human services, where the expenditure pressures are greatest. Put simply, the most expensive aspect of government spending is being borne by the level of government least able to

afford it. I think the really clear and graphic illustration of that is that the GST revenue going to the states has certainly consolidated state public finances. It is a solid growth tax. Even if you just look back at the last three years, where there has been an increase in state funding for public hospitals, that modest increase in funding has consumed 90 per cent of the GST growth dividend. That, I think, really demonstrates the gravity of the situation.

Obviously, there is an ongoing debate about reforming the funding of public hospitals. What the Rudd government has announced and what it has got in mind in terms of a public hospital reform plan does not seem to be adequate—\$2 billion to be available over the next four years. Maybe there is an element of rent seeking, but the AMA and the states say that it probably requires an extra \$1½ billion per year to meet the various shortfalls. So there are serious pressures there.

If we look over the forward estimates, total Commonwealth funding to the states is only projected to increase by 5½ per cent per annum in nominal terms. That is just above the rate of inflation, so the screws on the states are really going to be tightened. That is a continuation of the trend over the last couple of years under the coalition government. So there is not going to be a lot of money around.

From a public finance point of view, I think it makes sense to allocate the responsibility for the funding of hospitals to the Commonwealth, because they have the strongest tax base. You mentioned the Institute of Public Affairs submission. Given my knowledge of public finance, one thing that I am very certain about in terms of the broader debates about federalism is that the major growth taxes will need to be concentrated at the national level in the interests of efficient administration, in the interests of business having a harmonised tax system across the national economy and to prevent arbitrary rent seeking across state borders.

So the question then is: how do you organise a robust system to transfer the revenue that the states require to the states and how do you bring their spending responsibilities back into line? I think in terms of the basic politics and accounting, there is actually a nice fit in terms of the Commonwealth assuming responsibility for the funding of public hospitals in lieu of special-purpose payments. That means in essence that the states have financial and political independence over a smaller jurisdiction of areas. There would not be the blame and cost shifting associated with health and the management of hospitals, and also there would not be the problem of using special-purpose payments to coerce the states into making decisions which they may or may not be comfortable with.

In terms of the governance issue, depending on how the system is structured, there should be local input into the governance of hospitals. However, from talking to health professionals, health economists and health policy experts, in the history of Australia, in a community based governance system, the community based management of hospitals has been fairly poor. So I am really coming from the public finance perspective.

**CHAIR**—I think you note in your submission that Mr Rudd has said to the states, ‘Fix the hospital system or I’ll take them over.’ From what you say on the financial aspects, there is no way in the world the states are going to be able to fix the hospital system on the forward estimates of funding. So, if Mr Rudd is true to his word, it would seem to be almost a foregone conclusion that the Commonwealth will be taking over the public hospital system.

**Dr Eccleston**—Not at all, basically because of the politics and the costs associated, and this is not mismanagement in the Australian context. We know that health cost inflation is universal, irrespective of the type of health system that you have. It is running at 10, 11 or 12 per cent per year for a whole range of reasons that you are familiar with. So I think it is something of a poisoned chalice. The government does not really want to fund something that is going to be exorbitantly expensive given the demographic change and the broader history, and also in terms of the politics of providing quality health services. This has obviously been one of the motivations for state governments, particularly state governments who can afford it—I have spent the last 10 years in Queensland—to invest seriously, because at the end of the day they took the flak in terms of accountability for an underperforming public hospital system. So in terms of delivering services to middle-class consumers with high expectations which are going to be expensive, no-one really wants to do it. Again, I have been doing international research so I have not spent that much time in Canberra in the last couple of years, but I expect that this was what was going on for the coalition last year, where Tony Abbot, the health minister, expressed some interest in the takeover and then quickly backed down.

**CHAIR**—Looked at it.

**Dr Eccleston**—And I think that is what is going on with Labor federally. One issue in terms of funding is obviously these recently announced infrastructure funds. So there is \$11 billion for the Commonwealth under independent management to contribute to capital investment in the health sector, and that is not an insignificant amount of money; it could make a real difference. I am just coming up to speed on Tasmania's state budget and Tasmanian state politics, but obviously the issue here in Hobart is the need for a new Hobart hospital. The construction is estimated to cost about a billion dollars, which is enormous in the context of Tasmania's tiny state budget. Apparently the state government is planning to provide \$150 million per annum over the next six years to contribute capital to that project. That is going to be a big burden on the budget. It will be interesting to see whether they can fund the commitment next month. As you can imagine, obviously the state government and all the state premiers, health ministers and treasurers will be beating a path to Canberra to try to get some sort of access to that infrastructure funding. In context of the state budget, if the Commonwealth could fund a \$1 billion public hospital, that would free up resources. So it is possible under a revised system of special-purpose payments to get by. However, we still have the problems of accountability and the coercive nature of Australia's—

**CHAIR**—I thought you said that the forward estimates for Commonwealth payments to the states for hospitals was barely keeping pace with inflation. You note quite rightly that, at the current level and with increasing costs in health, it is simply not enough. Is your most recent statement—I do not want to put words in your mouth—that the only way the states will be able to do that is if they get additional special purpose payments particularly related to hospitals?

**Dr Eccleston**—Given the broad trends and the best evidence that we have, that appears to be the case. There can certainly be real gains and efficiency gains from better policy, better cooperation and so on, and let's hope that those dividends come to fruition and help the fiscal situation. But at an aggregate level of analysis, in funding for hospitals, let alone all the other areas where the states are under pressure, whether in infrastructure or in important social programs—and that has been something of a political story here in Tasmania—there will be problems. However, the other theme of this morning's session is the big issue of off-budget

revenue sources. We are not quite sure how funding from these infrastructure funds to the states is going to be dealt with in terms of the Commonwealth budget process. It is not included in the forward estimates in Budget Paper No. 3 of last week. Another broader issue is how we deal with off-budget debt and financial relationships between government and government business enterprises. It seems that, as well as the standard problem of unfunded superannuation liabilities, which are a problem for all states with the exception of Queensland, that is the major issue in terms of really assessing the financial position of individual states. There are ways of doing it beyond the estimates, but that has illustrated—

**CHAIR**—Someone will no doubt ask you about those other things. To conclude on the hospitals issue: if that is an original idea of yours to give away the special purpose payments in exchange for the Commonwealth taking over the hospital system, there was a pretty firm commitment made before the election that in two years the Commonwealth would take them over so it might be worth you patenting the idea and sending it to Canberra to help them achieve the goal.

**Dr Eccleston**—It is an idea that has been around and in terms of the numbers it kind of adds up. The problem is the politics. I do not know whether some of you know George Megalogenis, who I have worked with a little bit over the years and who writes for the *Australian* on tax matters. I think he is quite an insightful commentator. I noticed on Saturday in his column in the *Australian* he independently proposed the same sort of assessment of the evidence and structural pressures facing states, but with a slightly more politically palatable solution for a national government, a Commonwealth government, that wanted to maintain some control over the states. His proposal was to swap the responsibility for funding public hospitals, to have that go to the Commonwealth, in exchange for abolishing either payroll taxes or property transaction taxes. There would still be special purpose payments but it would be a fairly neat swap. The argument would be that we would be rid of one significant, arguably slightly inefficient, state based tax.

**CHAIR**—Now I know where he got his ideas from!

**Dr Eccleston**—No, I don't know. He is a good journalist, perhaps.

**Senator BUSHBY**—Thank you, Dr Eccleston, for a submission where I think your expertise is clearly evident. You have three possible solutions as part of your paper: one is the transferral of some revenue functions to the states; another is the hospitals, which we talked about; and the other one is fiddling with the SPPs and just basically continuing an incremental approach. It is a political question in a sense, but it seems to me that those options have always been open to us, and we have always had problems, and they have always taken the last option of incremental approaches for political reasons. The reality is that, unless you have a very brave Prime Minister or one who has to live up to an election promise, it is unlikely to happen. Do you think that is a fair comment, or can you see times changing in a financial sense to the point where something has to happen?

**Dr Eccleston**—I agree with you. Perhaps you should give me a lecture on the politics of taxation. My discipline, my area, is essentially political science. Because of the politics and the political constraints of significant reform that have distributional impacts and consequences, invariably tax reform and tax policy are an incremental process, until there is some broader kind of financial or political crisis or, occasionally, depending on the system—and I do not think the

Australian political system is conducive to it—courageous leadership. There are structural problems and we should not be complacent about the pressures that are likely to confront the states over the next five to 10 years. I think we are a long way off that crisis. There are significant concerns about health services and health funding. That is on the mainstream agenda, which it has not been historically. I am sure you are sensitive to that. It will be interesting to see what happens, but your committee's work is part of the process. There have been a number of reviews of the tax system, and we are back into that cycle of things. My colleague was laughing at me: 'You're going to be stuck in this tax gig for another five or 10 years, with another round of this to follow through.' At the end of the day, we have to be pragmatic.

But there are questions even with the incremental approach. Should it just be reactive, or should we have some broader dialogue and discussion about what the structural problems are with the system? In terms of the broader normative debates about federalism, what sort of federal system do we want? Do we want to preserve the political independence and the political and financial autonomy of the states, or do we want to move towards a more centralist system? I am frustratingly ambivalent or agnostic about those questions. I agree with the federalist ideal—I do not think there is much point having states if they do not have any real political independence—but, at the same time, some of the most significant reforms, particularly in economic but also social policy, have been driven by the Commonwealth. It can work either way, but I think it is a compromise of those issues.

Perhaps transferring the responsibility for the funding of expensive services from the states to the Commonwealth is one option. The other fundamental reform option that is more common among other federal countries is having a national tax base—income tax, capital taxes and consumption tax—and then a revenue-sharing agreement. That means you have the administrative and efficiency dividends of having a national tax system rather than bits and pieces of tax systems everywhere, a la the US, but the states do have some sort of independence in how much revenue they need and therefore accountability for putting a surcharge on top of the income tax system. As I mentioned, this was discussed in Fraser's new federalism but was never really acted upon.

**Senator BUSHBY**—In the IPA's evidence yesterday, when they suggested that the income tax be transferred to the states, they were only talking about personal income tax. They were still talking about it being collected by the Australian Taxation Office. Maybe, as part of the handover, you would start off with common tax rates, but then each of the states would have the flexibility to tweak it here and there to suit their own purposes. Do you think the constraints that they have put around it are more attractive than the concept of income tax simply being transferred to the states?

**Dr Eccleston**—I certainly do not advocate income tax being transferred to the states. The German model is a classic model. There is a flat federal income tax—it is 22 per cent at the moment—and then different states put a surcharge on that, and it varies depending on their financial needs, on whether they think offering marginally lower rates of income tax will help them attract professional migrants or whatever. That system seems to be a reasonable compromise for having the efficiencies of a national tax base while giving the states some financial independence.

In terms of the state sourced taxes, I am not an expert in state taxation per se. But one practical area for reform that is so important is for state taxes to be levied on a uniform base. That means that you have the same legal requirements about what constitutes a dutiable transaction in terms of property conveyancing. Different states can have different thresholds and different rates, but at the moment there is no harmonisation. I was talking to the director of the state revenue office. She said that this is a real problem. The nuances of individual state taxes are so obscure that accountants and lawyers are not trained in them. The national professional associations do not have the resources to train people in them. There are serious problems in the fact that when people get advice on what constitutes a dutiable transaction here in Tasmania it is wrong, because what constitutes a dutiable transaction under the state act is different to what it is in New South Wales or Victoria. That is basic area for reform.

**Senator BUSHBY**—Talking about fiscal capacity, what is it about Tasmania that is peculiar that leads to it only having 20 per cent of its revenue raised by state sourced taxes?

**Dr Eccleston**—That is the product of our system of fiscal equalisation, which as a Tasmanian I believe in. It is again a relatively unique characteristic of the Australian federal system. The fact is that, through the Commonwealth Grants Commission formula for reallocating general purpose payments—GST revenue—back to the states, Tasmania gets a lot more than they pay. There is a degree of cross-subsidisation. That means that in a small state that level of revenue is relatively more important. You are absolutely right: about 20 per cent of Tasmanian revenue comes from own sourced taxes.

**Senator BUSHBY**—Is that horizontal equalisation a self-perpetuating thing? Does having it there keep us at that level? Is it something that was introduced because we do not have the capacity to do otherwise?

**Dr Eccleston**—It was a compromise. It came out of the 1930s, when the Western Australians wanted to secede because they did not think that they were getting a very good deal. It has had a strong institutional base since then. One of the problems with the whole Commonwealth Grants Commission process is that it is very technical. It is based on need. Because more and more revenue is going through the Commonwealth Grants Commission process, the stakes are that much higher. This is one of the motivations for looking at this issue. All the serious literature of the financial implications of the GST for the states has really been on that distributional conflict. There was a recalibration of the distribution formula, which ironically favoured Queensland and Western Australia just when they were starting to experience the dividends of the resource boom, at the expense of Victoria and New South Wales. That is why my colleagues, like Neil Warren from ATAX, have been commissioned by Victorian and New South Wales governments to talk about this. The bottom line is that own source taxation is very marginal in Tasmania in terms of what state governments do. The decisions that state treasurers make and the pool of money that they have at their disposal are determined by the Commonwealth Grants Commission and the federal Treasurer.

**Senator BUSHBY**—I have a final question. This may not be in your area of expertise. You have mentioned that health costs are arising by about 10 per cent or 11 per cent. Everywhere we have been, we have asked questions about what the states are spending their money on. Although they have said that there has been money wasted, particularly in the health area, what is driving

the increase in costs in health? Is there any way that you can see of delivering health care that would avoid these massive increases in costs?

**Dr Eccleston**—One big caveat: I am not a health economist. But I follow the debates fairly carefully, and in short there is not. If you look at the American system, which is essentially a private system, or if you look at social democratic systems in Scandinavia or if you look at the NHS, the pressures are fairly similar, partly because of the professional power of the health industry, partly because of the exponentially increasing costs of health technology and partly because of the politics. You are dealing with the fundamentally important service for most middle-class Australian voters, and it is very hard to ration or deny that service. They are almost a given. Obviously, in terms of perverse cost shifting, duplications and so on—which we are more prone to in Australia because of the structure of the system—efficiencies can be made. But the idea of getting health costs to rise at one or two per cent above GDP or real growth does not happen anywhere in the world that has a credible health system. That is a challenge for you.

**CHAIR**—Did you say three per cent? That is right, isn't it? Hospital funding is outstripping GST growth by three per cent per annum.

**Dr Eccleston**—Yes. In nominal terms over the last three years, state funding for public hospitals has been increasing by around 12 per cent. Budget Paper No. 3 from last week under 'estimates of payments to the states' had nominal total Commonwealth funding to the states—this is 80 per cent of Tasmania's revenue—growing at 5.5 per cent. That is only one per cent above inflation. Tough times for state treasurers.

**CHAIR**—What was the 12 per cent figure?

**Dr Eccleston**—According to the Australian Institute of Health and Welfare—they are an independent institute and their data is fairly highly regarded and considered credible—total state contributions to public hospitals over the last three years for which data is available, and that finishes in 2006-07, was growing at 12 per cent. That makes sense in terms of the reference to the GST, because GST revenue has been growing at around nine per cent per annum.

**CHAIR**—I see. So it is 12 per cent compared to nine per cent. That is where you get your three per cent.

**Dr Eccleston**—That is right. It is interesting, because I took the three per cent straight from their report. But it makes sense in terms of thinking about revenue sources. That makes sense on those figures.

**Senator KIRK**—Thank you very much for your submission, Dr Eccleston. You have just been talking about GST revenue. What would be the implications for the states if there were to be a slow down in the economy and therefore a decrease in GST revenue? The way you have just described it, they are very much relying on that to fund public hospital services.

**Dr Eccleston**—That and special purpose payments. I am a cautious fan of GSTs from my first love! The great thing about them is that they are work horses, in the sense that consumption is relatively static and they keep delivering revenue year in, year out. They are not as vulnerable to variations in the economic cycle as other taxes. One thing that I can say is that GST revenues

have declined in overall terms to the states from 7.2 per cent of GDP down to 6.5 per cent. That is not a consequence of policy. It is due to the fact that in times of high economic growth the economy and income and company taxes are growing more quickly. The GST is a good insurance policy for the downturn. The real problem for the states is that their small, relatively inefficient own source tax revenue is very vulnerable. In a sense, the relatively good financial times that the states have experienced this decade so far are a consequence of the property boom. It is extraordinary. Sixty per cent of growth in state revenues has come from property transaction taxes. You do not even have to have a fall in property prices. Just a decline in volume will erode that revenue growth. I am not a property expert, but I would not mind betting that revenue growth in state own source taxes will probably halve over the next five to 10 years.

In some markets in Australia, we have seen volumes in the March quarter, because of rising interest rates, drop by 20 or 30 per cent. That is 20 or 30 per cent of that important revenue line item for the states. The states that have been doing relatively well have benefited from temporary pickups in terms of the property market. That was a major thing in terms of the Victorian state budget that was recently handed down. Here in Tasmania, the mid-year estimates were higher than expected just because there was a temporary resurgence in the Tasmanian property market in the last six months of last year. Fortunately, and I credit the state government for doing this, it was those kinds of windfall gains that they did not commit to recurrent programs. They used them for one-off social policy programs. That is the real point of vulnerability in terms of state revenues.

**Senator KIRK**—I was thinking as I was looking at your ideas about public hospital funding and the Commonwealth takeover of public hospitals and the way you describe that, as to whether or not you have considered other areas of public policy where the same kind of model may be implemented—Commonwealth takeover of education, for example? Have you thought beyond public hospitals?

**Dr Eccleston**—The public hospitals are, I think, a clear case because of cost pressures. Education is important and in any service based industry costs are increasing relatively quickly, but hospitals are the standout. The other reason to do it in Australia is that we have got for historical reasons this hybrid system, where two levels of government are both trying to provide health services. As we all know, that does not lead to efficient outcomes. So there are clear benefits to be made there.

**Senator CHAPMAN**—Reference was made earlier to the Institute of Public Affairs submission and evidence yesterday. What is your objection to their concept of states competing on the basis of either higher levels of taxation and providing greater services or lower levels of taxation and providing less services, and people making a choice in terms of where they want to live and work in that context?

**Dr Eccleston**—I will just clarify my position. There are two issues. One is that the states have their own taxation. They have got this exclusive right to impose income taxes, which will lead to significant differences, particularly in the way that taxes are administered. The German and Swiss model, which I support—and I think the IPA would support this as well—is that there is a Commonwealth base, 20 per cent or whatever it is, and then there is a surcharge on top of that that hopefully will vary across the states depending on their financial needs, depending on whether they go for a high-tax, high-service economy.

**Senator CHAPMAN**—So you are not objecting to the institute's principal, those powers of devolving revenue decisions and delivery decisions to the lowest possible—

**Dr Eccleston**—Well, circumscribed revenue decisions. What I do disagree with—and what I believe that the public finance literature strongly disagrees with—is this idea, despite the European trend, for all taxing and spending decisions to be devolved to states or even to local governments. It can work; it works in the US. But it is very inefficient, because what you end up with is a patchwork of different tax systems across a particular jurisdiction, and that leads to inefficient outcomes. This is particularly the case as competitive pressures increase, particularly since business is increasingly organised on a national scale and particularly with changes in technology—as we have become more mobile both in terms of where we work and the consumptions, decisions and so on. I do not think that is the right way to go. In terms of the federalist debate and trade-offs, as I have said, I am agnostic, but that is one important principle, I think.

**Senator CHAPMAN**—You have also referred to the increasing financial pressure on states. Some of the state oppositions would argue that part of the reason for that is waste or the misallocation of resources that the state governments have had. Part of their argument is that instead of going into, for instance, infrastructural areas of demonstrable need, state governments in recent years have simply employed more public servants. Have you examined that sort of issue?

**Dr Eccleston**—I have not looked into the detail, though I am pretty sure that expenditure growth has been much more rapid at the Commonwealth level than it has been at a state level. But we cannot generalise, because I guess one problem with this aggregate level analysis that I have provided is that there are significant disparities in terms of the financial situations across the states. Obviously, Western Australia and Queensland are in a privileged position. It is interesting that those states where the property markets, for example, have not been as strong, are those where treasurers and treasuries are having to think long and hard about alternative sources of revenue, whether it is privatising assets or whatever is the case in New South Wales. Certainly this is going to be an issue going forward in terms of sustainable efficient ways of funding the states.

Having a mature debate about deficits, how they are conceptualised and what they mean politically is important. A lot of the games that you are aware of like off-budget financial arrangements and borrowing from GBEs—which seems to have happened in Tasmania; I know it has certainly happened in Queensland in the late nineties—are all the product of a relatively immature and ill-informed debate on what deficits mean.

**Senator FORSHAW**—I do not have any additional questions. Thank you for your submission; it is very comprehensive. I want to clarify a couple of figures. You referred to the \$11 billion health fund.

**Dr Eccleston**—The new infrastructure announcement on Tuesday night?

**Senator FORSHAW**—Yes. I hate to correct you; it is actually less. It is \$10 billion. But the education investment—

**Dr Eccleston**—That is my self-interest coming through.

**Senator FORSHAW**—The other figure you use is the \$2 billion public hospitals reform plan, which is referred to in your submission. Where do you get that figure? Is that a pre-budget figure?

**Dr Eccleston**—Yes. There have been other initiatives there.

**Senator FORSHAW**—I am not trying to be picky. The figure given in the Treasurer's speech—I admit I do not have all the budget papers with me—refers to an extra \$3.2 billion over five years.

**Dr Eccleston**—For health?

**Senator FORSHAW**—Yes. That is under 'Better hospitals and better services' incorporating the National Health and Hospitals Reform Plan. I am happy to go and check but I wonder whether you were aware of that figure from the budget speech.

**Dr Eccleston**—No.

**Senator FORSHAW**—The \$2 billion is part of the \$3 billion.

**Dr Eccleston**—The \$2 billion is the pre-election pledge. Obviously the situation has changed since then. I guess the \$3.2 billion has probably—

**Senator FORSHAW**—You said over four years, too, I think.

**Dr Eccleston**—The pre-election policy was \$2 billion over four years.

**Senator FORSHAW**—Whereas this is a figure of \$3.2 over five years. I am just trying to make sure that we are talking about the same issue.

**Dr Eccleston**—The issue is budgets. I am inherently professionally cynical. I always tell my students and anyone else who will listen that you look at the numbers; you ignore the speech, the media and so on. This is a lesson I picked up from a book by an eminent American political scientist Aaron Wildavsky written in the early seventies. It is about the politics of the budgetary process. I had it on my bookshelf for a year before I picked it up. It is a fantastic read. It is like an episode of *West Wing*, about the wheeling and dealing on the hill. One of the points that came out of that is: just look at the bottom line in terms of where the money is coming from. Forget what ministers and treasurers say, look at the bottom line.

The only thing I did bring along with me today is the bottom line in terms of estimates of total transfers to the states over the forward estimates. I was shocked at how modest they are. This implies that if, on the forward estimates, there has been a commitment to increase funding for public hospitals to the states from \$2 billion to \$3.2 billion—

**Senator FORSHAW**—This is—

**Dr Eccleston**—I guess my point is that there will be substitutions in other areas. That will have implications for financial sustainability. Those pressures are there.

**Senator FORSHAW**—I am not trying to make any political point.

**CHAIR**—Of course not.

**Senator FORSHAW**—I am trying to ascertain whether we are talking about the same thing. When I read your submission I picked up that it was probably written before the budget.

**Dr Eccleston**—Yes.

**Senator FORSHAW**—I am trying to ensure that we are talking about the same thing—that when you talk about the \$2 billion, that is now the \$3.2 billion figure—or whether there is something else. I can check it when I get back to Canberra. The only document I have at the moment is the speech. I will not debate the issue of whether you take any notice of it. The speech refers to \$3.2 billion over five years for better hospitals and health services—and this is separate.

**Dr Eccleston**—And obviously with the benefits of incumbency, with the first-round negotiations with state health ministers, perhaps there is a determination to allocate more funding to health. What I was surprised at—and this was George Megalogenis's comment—given the priority and the importance of federalism in terms of the election campaign and for the first term of the Rudd government, was how modest increases in funding to the states were. I was quite shocked, and I was kind of reassured when Megalogenis, using his poetic licence, described funding as as flat as the tarmac at Tullamarine. There is just no extra money there.

**CHAIR**—Where did you get that from?

**Dr Eccleston**—This is from Budget Paper No. 3, which is on intergovernmental financial relations.

**CHAIR**—Do you have the page there?

**Dr Eccleston**—No, I do not. I can send the secretary that.

**Senator FORSHAW**—Just to go back, you said there was \$2 billion over four years, and I was only aware of \$3.2 billion over five. I was not sure whether you were arguing that it is actually only \$2 billion over four years.

**Dr Eccleston**—No. The indications are that your information is more up to date. Whether or not hospitals require \$6 billion, I do not know. There is obviously going to be a fair bit of rent seeking. We all know that throwing money at problems does not necessarily resolve them, but it is an important part of the equation.

**CHAIR**—On that, you say in your paper that the states—I assume collectively—need an additional \$1.5 billion per annum over and above what they were getting.

**Dr Eccleston**—The AMA also says that, and I have also seen a paper from Stephen Duckett—who I think was working for the Queensland government, so was probably not particularly independent, but he was obviously an eminent academic health economist before he started consulting for state governments—and that seems to be the sort of figure that has been raised.

**CHAIR**—So Senator Forshaw's figure of \$3.2 billion over five years is about half of what the states say they need, which would be \$7.5 billion over five years.

**Dr Eccleston**—Exactly.

**Senator FORSHAW**—But it is true, isn't it—and I will make the political point in the question—that the states have been saying ever since about 1996 that they have a huge shortfall of funding for public hospitals. They have been using the figure of \$1.5 billion consistently. Go back to the 1996-97 budget—

**CHAIR**—That is not political.

**Senator FORSHAW**—It is. The states did not start saying they had a \$1.5 billion shortage per year yesterday or on whatever date it was that the budget—

**CHAIR**—This is in 2007.

**Senator FORSHAW**—They have been saying it for 10 years.

**CHAIR**—This is a 2007 report done by the Queensland government, no doubt to make the point against the then federal government, but it still applies today.

**Dr Eccleston**—It is a pity that it is not my area of expertise and I do not have the figure in my head. But in terms of the total investment in public hospitals in the Australian system, depending on how it is conceptualised and defined, it is relatively large across the OECD.

**CHAIR**—Are you finished, Senator Forshaw?

**Senator FORSHAW**—Only to remind you that there is the \$10 billion fund—

**CHAIR**—No, finished questioning, not political—

**Senator FORSHAW**—Yes, I have finished questioning.

**Dr Eccleston**—That is the wild card. That could really help the states in the short term.

**CHAIR**—Can I just get back to this table which you have alerted us to. The Commonwealth payments to the states in the year 2007-08 were \$74 billion and rose five per cent by 2001-12 to \$91 billion, which is an increase of \$17 billion.

**Dr Eccleston**—That is right—5½ per cent in nominal terms. That is not adjusted for inflation. In terms of revenue and funding growth and the cost of government, that is very modest. During

the early years after the intergovernmental agreement, total resources to the states—including transfers, GST revenue, special purpose payments and own-sourced revenue—grew by around eight per cent in nominal terms—at a time when inflation was significantly, 1½ per cent, lower. So basically we are looking at total financial resources available to the states dropping from five per cent growth in real terms down to one per cent.

**CHAIR**—In real terms, after allowing for inflation?

**Dr Eccleston**—Exactly. That is right.

**CHAIR**—So you are saying that, of the \$17 billion increase, \$15 billion will be inflation.

**Dr Eccleston**—Yes.

**CHAIR**—I wonder if the states are aware of that figure. Dr Eccleston, thank you very much.

**Dr Eccleston**—Thank you for inviting me.

**CHAIR**—It was a very interesting submission. I appreciate your time in putting it together and particularly your time in coming and talking to us today.

**Dr Eccleston**—My pleasure. Thank you for putting up with my lecture this morning!

**CHAIR**—Thank you very much.

**Committee adjourned at 1.07 pm**