TARGET30
REDUCING THE BURDEN FOR FUTURE GENERATIONS

THE CENTRE FOR INDEPENDENT STUDIES

Report Card on State Finances

Robert Carling

Research Report | February 2017

National Library of Australia Cataloguing-in-Publication Data:

Report Card on State Finances

Robert Carling

TARGET30
REDUCING THE BURDEN FOR
FUTURE GENERATIONS

THE CENTRE FOR
INDEPENDENT
STUDIES

Research Report 23

Related CIS publications

TARGET30

T30.07 Robert Carling, *States of Debt* (2014)

Issue Analysis

IA124 Robert Carling, *Tax, Borrow, Spend: How the States Compare* (2011)

Contents

ACKNOWLEDGEMENTS

Lily Havers provided invaluable research assistance in the preparation of this report while she was an intern with the CIS. However, the views expressed, and any errors in the report, are the responsibility of the author.

Introduction

The plight of Commonwealth government finances has been well publicised. Having lurched from surplus to deficit in the global financial crisis of 2008, the budget has remained heavily in deficit ever since, with deficits of around the $40 billion mark in each of the past four years. Commonwealth gross debt has risen from $67 billion in June 2007 to $502 billion in June 2016, and net debt from negative $31 billion — that is, financial assets exceeded gross debt — to $297 billion over the same period (see Appendix 2).

Finances of the state governments are also important, and they are the main focus of this report.

State finances also deteriorated sharply after 2007, but their profile since then has been quite different from that of the Commonwealth. The first approach of this report is to examine relevant aggregates of the states and territories, before analysing the situation of each state.

State aggregates

A useful starting point in examining state finances is the performance measure the states themselves emphasise in their own reporting — namely the net operating result.[1] (Terms such as 'net operating result' are defined in Appendix 1.) As Figure 1 illustrates, the states in aggregate recorded a net operating surplus of more than $7 billion in 2006–07, which then shrank and turned into deficit in 2012–13, since when there has been a near full recovery.

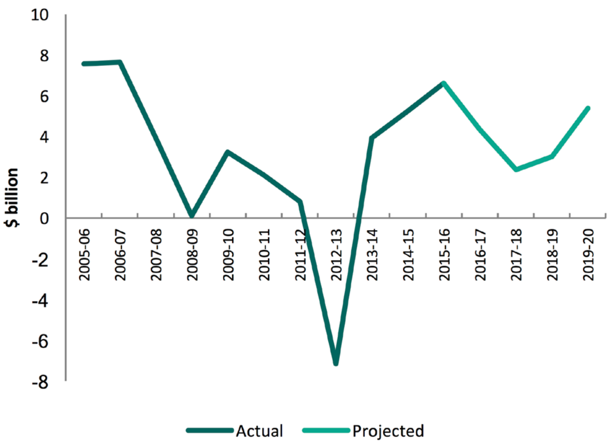
The fact that the states are in operating surplus means that revenue is in excess of operating expenses such as employee expenses, interest on debt and depreciation of assets. This outcome stands in stark contrast to the Commonwealth, which remains heavily in operating deficit and in that sense is borrowing to finance day-to-day operations. This difference between the Commonwealth and the states largely reflects the different influences on the revenue side of their respective budgets, with the Commonwealth suffering from weak income tax revenue and the states (it must be emphasised, in aggregate) enjoying buoyant property tax revenue, which has allowed total operating revenue to recover relative to operating expenses (see Figure 2).

States' budget estimates for the current and subsequent years show a decline in the net operating surplus, particularly as the growth in the aforementioned property tax revenue subsides.

While the states are recording operating surpluses, it must be emphasised that these do not include capital expenditures, which for the states are a significant outlay. As shown in Figure 3, capital expenditure (as represented by 'net acquisition of non-financial assets' in the official government finance terminology) rose to as much as $18 billion in 2009–10 before falling back, and is projected to rise rapidly again in the next few years, particularly as New South Wales ramps up infrastructure spending.

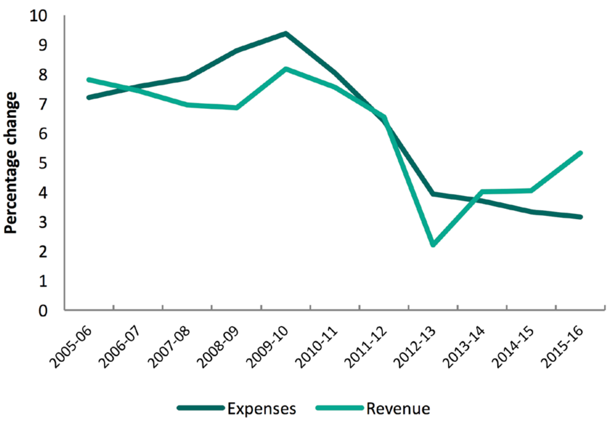
Capital outlays must be deducted from the net operating result to determine the net borrowing or lending position of the states, or what is also called the fiscal balance. The fiscal balance is closer to what the Commonwealth reports as its budget result (the underlying cash deficit/surplus), and on the fiscal balance measure the states, like the Commonwealth, have been in deficit every year since 2007–08. As shown in Figure 4, however, the states' position has recovered more markedly than the Commonwealth's, for the reasons stated above in relation to the net operating result. Reflecting the large planned increase in capital expenditures, the states' fiscal balance is estimated to return to larger deficits in the next few years.

Figure 1: Net operating balance of states and territories



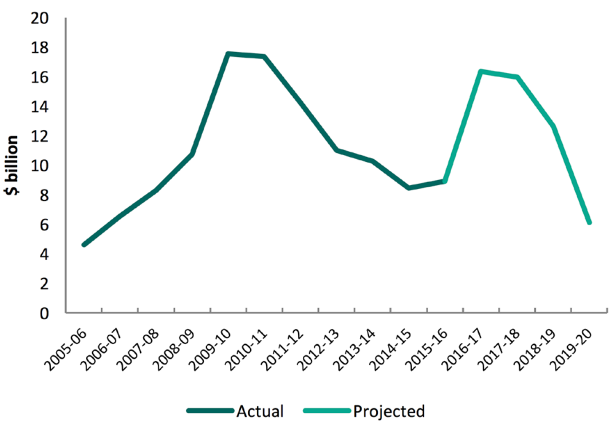
Sources: State financial reports for 2015-16; ABS (Australian Bureau of Statistics), *Government Finance Statistics*, *Australia*, *2014-15*, Cat. No. 5512.0 (Canberra: ABS, 2016).

Figure 2: States' three-year moving average gorwth in operative revenue and expenses (% pa)



Sources: State financial reports for 2015-16; ABS (Australian Bureau of Statistics), *Government Finance Statistics*, *Australia*, *2014-15*, Cat. No. 5512.0 (Canberra: ABS, 2016).

Figure 3: Net acquisition of non-financial assets of states and territories



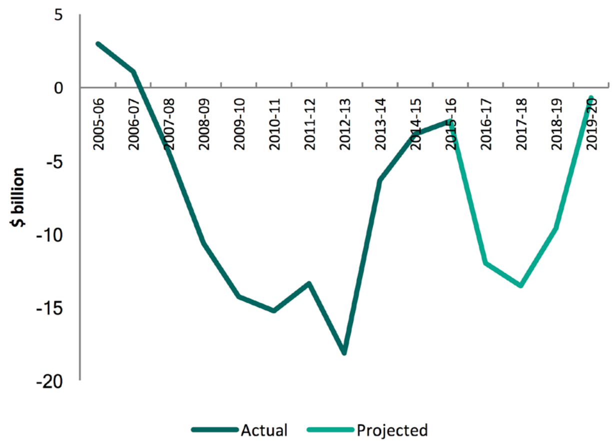
Sources: State financial reports for 2015-16; ABS (Australian Bureau of Statistics), Government Finance Statistics, Australia, 2014-15, Cat. No. 5512.0 (Canberra: ABS, 2016).

Other key measures of aggregate state fiscal performance are the balance sheet measures of net debt and net financial liabilities of the general government sector and the broader non-financial public sector (NFPS).[2] As shown in Figure 5, general government net debt went from a negative level in June 2007 to $43 billion in 2016. The 2016 figure would have been much higher had it not been for the proceeds of public enterprise privatisations, particularly in New South Wales. As these proceeds are released for spending on infrastructure over the next several years, and as most other states continue to record deficits on the fiscal balance measure, net debt is estimated to increase sharply to almost $90 billion by June 2020. That level will still be dwarfed by the Commonwealth's net debt (estimated at $364 billion), but at more than 30% of estimated total state revenue, it is an historically high figure for the states.

Net financial liabilities are a broader measure of the stock of financial obligations, which include the unfunded public sector superannuation liabilities carried on states' balance sheets as well as their debt liabilities. As shown in Figure 6, the addition of unfunded superannuation liabilities makes a big difference, taking general government net financial liabilities to $252 billion at June 2016, or 104% of revenue.

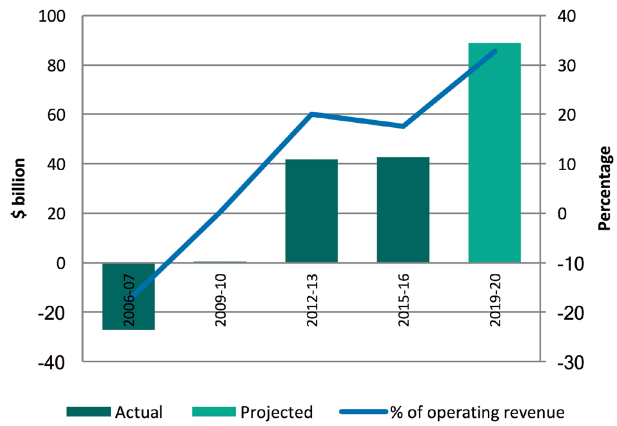
Figures 5 and 6 refer to the general government sector, which does not include government trading enterprises such as those for water and (in some states) electricity. Although these entities are run on a commercial basis and their debts are supported by their own revenues, state governments are ultimately responsible for them, and for this reason some analysts (such as the credit ratings agencies) also consider debt of the non-financial public sector as a whole. As Figure 7 shows, net debt is much higher on this basis at $148 billion in June 2016, rising to an estimated $204 billion by 2020.

Figure 4: Net borrowing/lending of states and territories



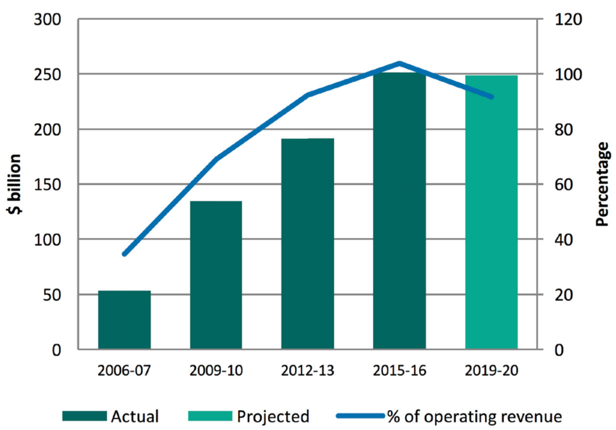
Sources: State financial reports for 2015-16; ABS (Australian Bureau of Statistics), *Government Finance Statistics*, *Australia*, *2014-15*, Cat. No. 5512.0 (Canberra: ABS, 2016).

Figure 5: General government net debt of states and territories



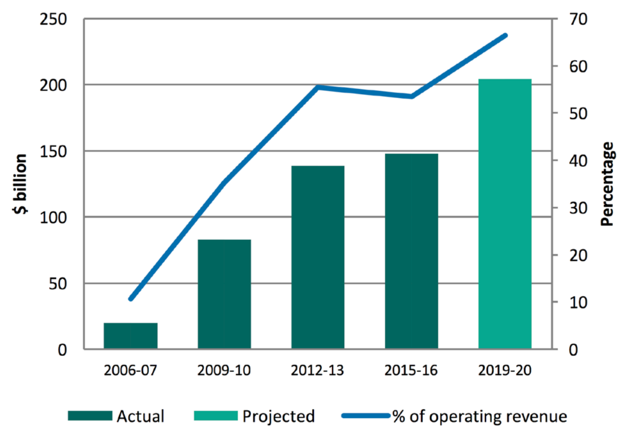
Sources: State financial reports for 2015-16; ABS (Australian Bureau of Statistics), *Government Finance Statistics*, *Australia*, *2014-15*, Cat. No. 5512.0 (Canberra: ABS, 2016).

Figure 6: General government net financial liabilities of states and territories



Sources: State financial reports for 2015-16; ABS (Australian Bureau of Statistics), *Government Finance Statistics*, *Australia*, *2014-15*, Cat. No. 5512.0 (Canberra: ABS, 2016).

Figure 7: Non-financial public sector net debt of states and territories



Sources: State financial reports for 2015-16; ABS (Australian Bureau of Statistics), *Government Finance Statistics*, *Australia*, *2014-15*, Cat. No. 5512.0 (Canberra: ABS, 2016).

Is there 'good' debt and 'bad' debt?

There is nothing to say that the optimal level of state debt is zero. Attempting to distinguish between right and wrong reasons for governments to incur debt the federal Treasurer, Scott Morrison, recently referred to 'good' and 'bad' debt.[3] To paraphrase Morrison's argument, the former is incurred to finance sound public investments, while the latter is incurred to finance recurrent expenditure. A related idea from public finance literature is the so-called 'golden rule', which holds that governments should only borrow to finance public investment, while recurrent expenditure should be covered by current revenue – at least on average over the business cycle, if not each and every year. The economic underpinning of the golden rule is that public investment generates future economic growth and tax revenue from which the debt used to finance them can be serviced.

The states could draw some comfort from the golden rule, as the build-up of debt in recent years has – at least for the states in aggregate -- not reflected net operating deficits, but rather an elevated level of capital expenditure. However, the golden rule is subject to major qualifications in its practical application. Much of what is classified as government capital expenditure has little or no connection to future economic growth or state revenue, and even genuine economic infrastructure projects are not necessarily rigorously selected according to cost-benefit criteria or implemented at an efficient cost.

As public finance expert Vito Tanzi has written:

> "........ there would be disagreement among economists on whether *routine* public investment spending(spending that does not change much year after year) should be financed by credit, rather than by current revenue, as defenders of the so called *golden rule* have argued that it should. Not all what is called public investment is productive, and not all contributes to economic growth and to future public revenue. The public spending classified as investment is often inflated by "white elephants", investments on "roads to nowhere", and expenses that may reflect corruption, rent seeking or other forms of opportunistic behaviour. This kind of "public investment" contributes neither to economic growth, nor to future public revenue. However, it does inflate the public debt and the future costs of servicing the debt. It also reduces future economic growth. Furthermore, there continues to be a debate among accountants as to what kind of spending should be defined as public investment, thus allowing less scrupulous governments to classify some current expenses as investment. The use of the golden rule encourages these actions."[4]

For such reasons, it would be a mistake to think that state governments need do no better than balance their operating budgets, while borrowing every dollar classified as 'capital' expenditure. Operating surpluses should be the norm, and should be large enough to finance what Tanzi describes as 'routine public investment spending (spending which does not change much year after year)'. Borrowing should only be used to finance large, one-off economic infrastructure projects with a demonstrable link to future economic and revenue growth. Even then, total debt should always be kept to a prudent level.

Comparative performance of individual states

Fiscal aggregates for all the states and territories combined are important in analysing the national economy and the public sector's total call on resources. However, for political accountability and analysis of the differences in fiscal performance among the states, it is necessary to examine and compare the data for each state. In fact, there has been much diversity in fiscal performance among the states in recent years, which is masked by the aggregates. At one extreme, New South Wales has recorded a pronounced strengthening in the state's fiscal position; while at the other extreme, Western Australia has deteriorated sharply.

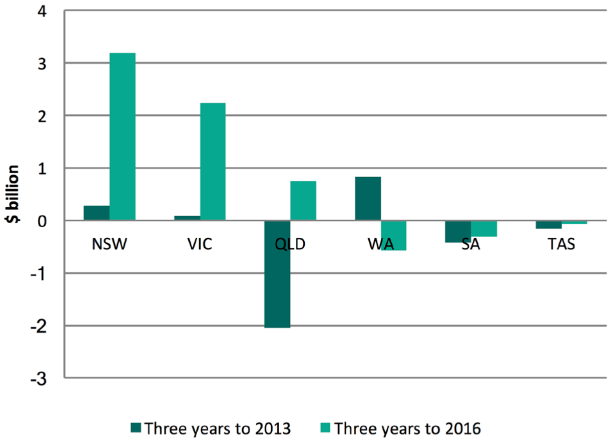
This section of the report compares the performance of individual states by considering various indicators of the budget balance, debt and other financial liabilities, spending and taxation. The report examines both the positions at June 2016 and the trend over the preceding three years. While the states' budget estimates for 2016-17 and the forward estimates to 2019-20 may tell a somewhat different story, the emphasis in this analysis is on actual past results rather than estimates and projections that experience has shown can be unreliable.

Indicators of the budget balance

(a) Net operating result

Based on the average net operating result in the three years to 2015–16, the budget result improved in all states except WA compared with the preceding three years. The largest three states recorded average surpluses, with NSW boasting the best budget result. Victoria and Queensland also recorded net operating surpluses. NSW and Queensland stand out with particularly substantial improvements, and in the latter case with a large turnaround from a deficit in the previous period. The position of Western Australia has declined markedly from surplus to substantial deficit given ongoing revenue challenges.

Figure 8: Average net operating result

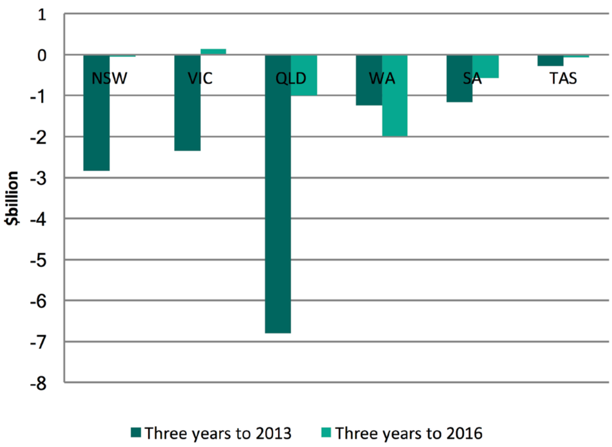


Sources: State financial reports for 2015-16; ABS (Australian Bureau of Statistics), *Government Finance Statistics*, *Australia*, *2014-15*, Cat. No. 5512.0 (Canberra: ABS, 2016).

(b) Fiscal balance

On the more stringent fiscal balance measure (which deducts net capital expenditure from the operating result), there was an improvement in all states except Western Australia (Figure 9). This resulted in close to balanced budgets in NSW, Victoria and Tasmania, but the other states remained in substantial deficit. Queensland's remarkable improvement in the fiscal balance is mainly due to tighter control of operating expenses, a reduction in capital expenditure from historically high levels, and lately the higher royalty revenue driven by a surge in coal prices.

Figure 9: Average net lending/borrowing



Sources: State financial reports for 2015-16; ABS (Australian Bureau of Statistics), *Government Finance Statistics*, *Australia*, *2014-15*, Cat. No. 5512.0 (Canberra: ABS, 2016).

Indicators of debt and other financial liabilities

(a) General government net debt

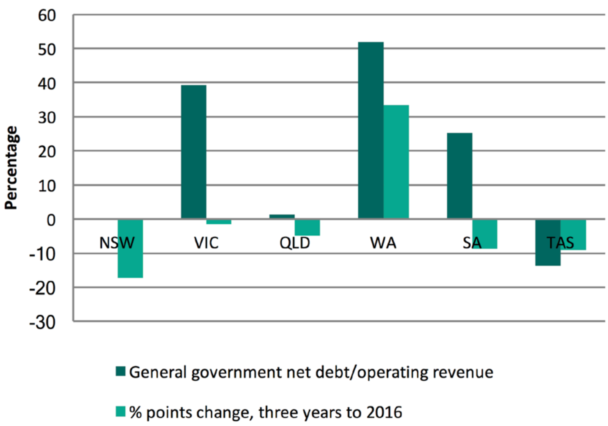
General government net debt as an absolute magnitude is meaningless without being related to some measure of the capacity to service debt. While analysts often use GDP (or in the case of a state, GSP) for that purpose, a better measure is the annual revenue flow from which debt must be serviced. For example, one of South Australia's fiscal targets is that general government net debt should not exceed 35% of annual operating revenue.

However, no such rule can be hard and fast, as sustainability also depends on factors such as the expected future growth rate of revenue, the trend of debt levels, and the credibility of government policy actions to address any looming debt problem.

With those qualifications in mind, Figure 10 compares the six states' ratios of general government net debt to operating revenue at June 2016 and the change in the three years to June 2016.

The net debt burden has fallen in all states except Western Australia. Western Australia's net debt burden has grown enormously, exceeding the 35% guideline referred to above and standing significantly above all the other states. The rate of increase reflects the substantial decline in general government revenue and ongoing high levels of investment in infrastructure. NSW's net debt has fallen close to zero thanks to proceeds from the privatisation of ports and the long-term leases of TransGrid and Ausgrid. However this is only a temporary situation as there are plans to spend the proceeds on infrastructure.

Figure 10: States' general government net debt as a percentage of operating revenue, 2016



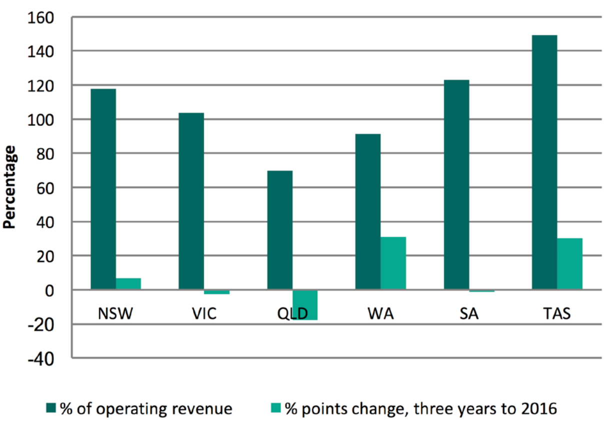
Sources: State financial reports for 2015-16; ABS (Australian Bureau of Statistics), *Government Finance Statistics*, *Australia*, *2014-15*, Cat. No. 5512.0 (Canberra: ABS, 2016).

(b) General government net financial liabilities

Net financial liabilities (NFL) are a broader concept than net debt, as they include future non-debt financial obligations, which are mainly unfunded superannuation liabilities of defined benefit pension schemes for state employees. Most of those schemes have now been closed, but they will continue to pay indexed pensions to pre-existing employees for many years to come. Although all states have built up financial assets earmarked to pay future pensions, large unfunded gaps remain. This is why NFL burdens are much higher than net debt burdens. They have also increased more than net debt burdens in recent years due to reduced discount rates for future liabilities and increased expected longevity of defined benefit scheme members.

As shown in Figure 11, general government NFL is above 100% of revenue in all states except Queensland and Western Australia. Tasmania has the highest ratio. Queensland experienced the greatest drop, while Victoria and South Australia's NFL ratio also fell slightly. The largest increases were in Western Australia and Tasmania.

Figure 11: States' general government net financial liabilities as a percentage of operating revenue, 2016



Sources: State financial reports for 2015-16; ABS (Australian Bureau of Statistics), *Government Finance Statistics*, *Australia*, *2014-15*, Cat. No. 5512.0 (Canberra: ABS, 2016).

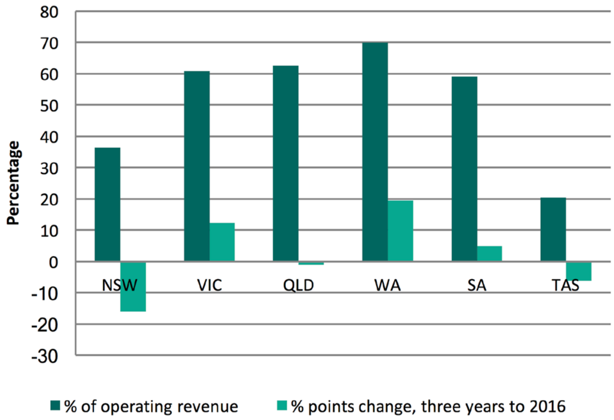
(c) Non-financial public sector net debt

NFPS net debt is higher as a percentage of revenue than general government net debt because government trading enterprises tend to have high debt ratios.

Western Australia, Queensland, South Australia and Victoria have the highest debt burdens on this measure, and Tasmania the lowest (Figure 12). New South Wales had the greatest decrease in the three years to June 2016, while Western Australia had the largest increase.

Assessing the affordability of net debt levels in the NFPS is more difficult than for the general government sector because the sustainability of government trading enterprise debt depends on the profitability of the investments financed by the debt. In principle, government trading enterprises are mandated to remain commercially viable and keep their debts at manageable levels, just as if they were privately owned. Nonetheless, Western Australia specifies as one of its financial targets maintaining NFPS net debt at or below 55% of the sector's revenue — a figure it now far exceeds. If this target were applied to the other states, only NSW and Tasmania managed to meet it in 2015-16.

Figure 12: States' non-financial public sector net debt as a percentage of operating revenue, 2016



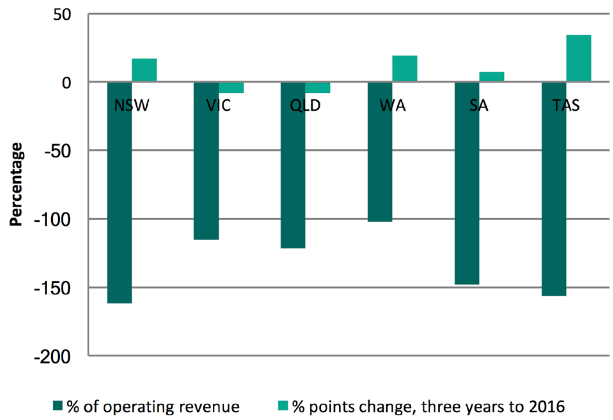
Sources: State financial reports for 2015-16; ABS (Australian Bureau of Statistics), *Government Finance Statistics*, *Australia*, *2014-15*, Cat. No. 5512.0 (Canberra: ABS, 2016).

(d) Non-financial public sector net financial worth

The broadest measure of public sector financial health is net financial worth (NFW) of the non-financial public sector. Relating this to NFPS revenue, Figure 13 shows that NFW is negative in all states. This is not surprising, as NFW was negative even when states' financial strength was at its peak before the global financial crisis. Net financial worth has deteriorated in all states except Victoria and Queensland. Negative NFW now exceeds 100% of revenue in all states. NSW, South Australia and Tasmania have the highest negative readings, and the largest deterioration in the three years to 2016 was in Tasmania.

Negative NFW in itself does not mean that a state is bankrupt, because NFW only takes into account financial assets. The states also have very large physical assets, which are enough to put them into a positive overall net worth position, albeit one that has weakened in recent years.

Figure 13: States' non-financial public sector net financial worth as a percentage of operating revenue, 2016



Sources: State financial reports for 2015-16; ABS (Australian Bureau of Statistics), *Government Finance Statistics*, *Australia*, *2014-15*, Cat. No. 5512.0 (Canberra: ABS, 2016).

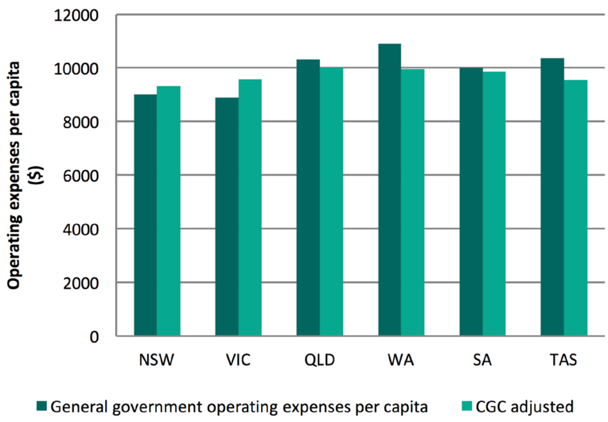
Indicators of spending

(a) Operating expenses per capita

The level of general government operating expenses per head of population is an indicator of each state government's propensity to spend. Variations among the states partly reflect intrinsic advantages and disadvantages in service delivery, as well as differences in policies and service levels. To put the states on a more comparable footing, we adjust observed levels of spending per capita up or down by the Commonwealth Grants Commission's (CGC) assessment of the intrinsic advantages and disadvantages (Figure 14: At the time of writing, CGC data are only available to 2014-15). Queensland, Western Australia and South Australia have expenses per capita well above the average, while New South Wales is clearly below.

Without the CGC adjustment noted above, Western Australia's operating expenses are the highest at almost $11,000 per capita while Victoria's are the lowest at less than $9,000.

Figure 14: States' general government operating expenses per capita, 2015-16



Sources: State financial reports for 2015-16; CGC (Commonwealth Grants Commission), *Report on GST Revenue Sharing Relatives*, 2016 (CGC: Canberra, 2016).

(b) Growth of real per capita expenses

Comparative growth in general government expenses is best assessed after adjustment for population growth and inflation. Figure 15 shows the growth in real per capita expenses in each state in the most recent three years. On this measure, NSW, Queensland and South Australia have managed to cut expenses. In Queensland's case, this represents a large turnaround from growth in expenses in the previous three years. Meanwhile, Western Australia stands out as continuing to have high expenditure growth.

Figure 15: Percentage change in real per capita operating expenses for each state, three years to 2015-16

Sources: State financial reports for 2015-16; ABS (Australian Bureau of Statistics), *Government Finance Statistics*, *Australia*, *2014-15*, Cat. No. 5512.0; Consumer Price Index, Australia, June 2016, Cat. No. 6401.0; *Australian Demographic Statistics*, *June 2016*, Cat. No. 3101.0 (Canberra: ABS, 2016).

(c) Public sector employment

As payroll is by far the largest expense of state governments, it is important to focus on levels and trends in the number of state public sector employees. The number per 1,000 of population is shown in Figure 16, along with an adjusted figure that incorporates the CGC adjustment described above for per capita expenses. On average, states employed around 63 people per 1,000 of population. Both with and without the CGC adjustment, South Australia and Tasmania were well above this average.

Figure 16: States' general government public sector employment per thousand of population, June 2016

Sources: ABS (Australian Bureau of Statistics), *Employment and Earnings*, *Public Sector*, *Australia*, *2015-16*, Cat. No. 6248.0.55.002 (Canberra: ABS, 2016); CGC (Commonwealth Grants Commission), *Report on GST Revenue Sharing Relatives*, *2016* (CGC: Canberra, 2016).

(d) Growth in state public sector employment

For purposes of comparison, the growth in state public sector employees is best adjusted for population growth. Figure 17 shows the results for the latest three years. Queensland experienced the greatest increase in employment per 1,000 of population, which represented a major turnaround from the decline in the previous three years. Only Western Australia and Tasmania had declines in employment in the latest three years.

Figure 17: Percentage change in government employment per capita for each state, three years to June 2016

Sources: ABS (Australian Bureau of Statistics), *Employment and Earnings*, *Public Sector*, *Australia*, *2015-16*, Cat. No. 6248.0.55.002 (Canberra: ABS, 2016).

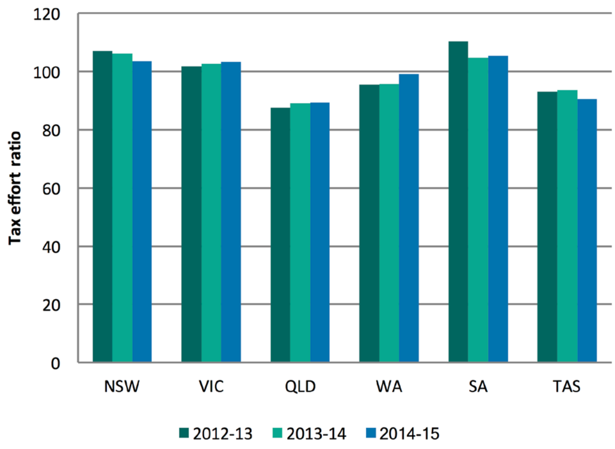
Revenue indicators

(a) Tax burden

The comparative burden of state taxation is not well represented by measures such as tax revenue per capita or revenue as a proportion of gross state product. Variations in these measures across the states are heavily influenced by differences in taxable capacity as well as in state tax policies. A better indicator of the relative burden of state taxation resulting from states' policy choices is provided by the Commonwealth Grants Commission's measure of relative tax effort. This is shown for selected years in Figure 18, along with total revenue effort ratios in Figure 19.

The indicators displayed in figures 18 and 19 say nothing about the absolute burden of each state's tax and other revenue policies, but they do provide a rough indication of the relative burden. Queensland, Western Australia and Tasmania are all below the average tax raising effort. South Australia continues to have the heaviest tax burden, but has reduced it significantly. Queensland's and Western Australia's tax burdens have gone in the other direction as they have raised more tax revenue in response to the large budget deficit.

Figure 18: Tax effort ratio in each state, 2012-15

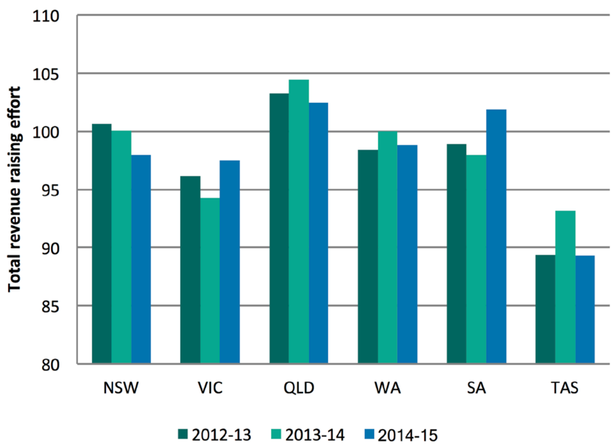


Sources: CGC (Commonwealth Grants Commission), *Report on GST Revenue Sharing Relatives*, *2016* (CGC: Canberra, 2016).

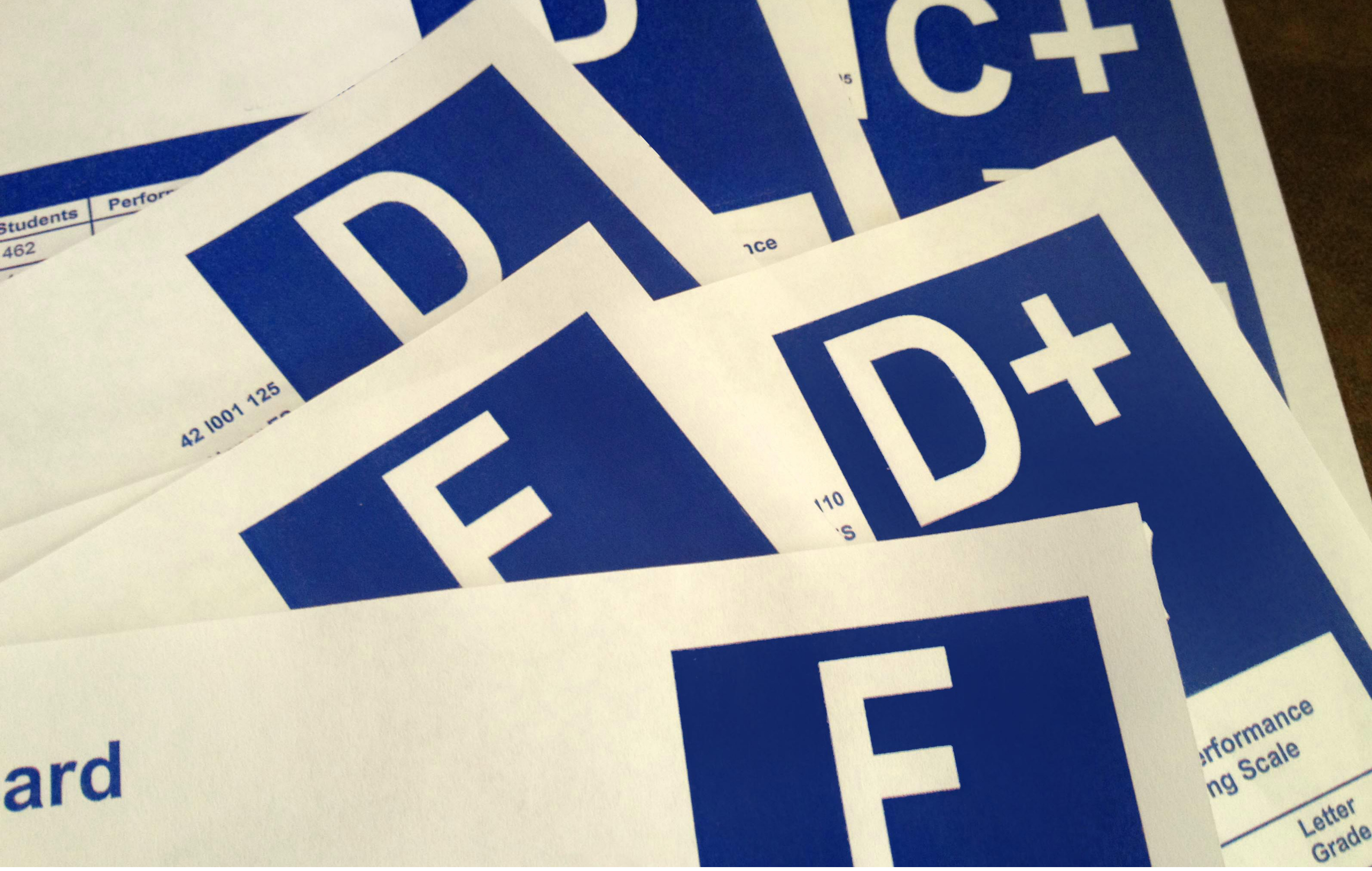
(b) Revenue effort

The total revenue effort ratios in Figure 19 tell a similar story, except that despite Queensland's low taxes, it is an above-average revenue raiser — with coal royalties representing a relatively large source of revenue.

Figure 19: Total revenue raising effort in each state, 2012-15



Sources: CGC (Commonwealth Grants Commission), *Report on GST Revenue Sharing Relatives*, *2016* (CGC: Canberra, 2016).



The report card

Any single summary measure of state financial strength is fraught with difficulty. This includes credit ratings issued by agencies such as Moody's and Standard & Poor's, which overlay judgement on top of an array of financial indicators. Table 1 shows these agencies' latest ratings for each of the states, ranked from strongest to weakest.

Table 2 takes a different approach, by summarising all the fiscal indicators set out above in the section on comparative performance of individual states, and doing so within a normative framework that favours both fiscal prudence and smaller government. This is consistent with the Target30 campaign of The Centre for Independent Studies, which promotes the objective of reducing the overall size of general government (for all tiers of government combined) from its recent level of around 36% of GDP to 30%.[5] Thus, states with lower government spending and/or that have reduced their operating expenditure or taxation in recent years — other factors being equal — are ranked above states that have gone in the other direction. The credit rating agencies, in contrast, are neutral with respect to the size of government, provided enough revenue is being raised to make it financially sustainable.

Table 1: State credit ratings

Standard & Poor's		Moody's	
1 & 2. NSW & VIC	AAA/negative outlook*	1 & 2. NSW & VIC	Aaa/stable outlook
3 & 4. QLD & TAS	AA+/stable outlook	3. SA	Aa1/stable outlook
		4. QLD	Aa1/negative outlook
5. WA	AA+/negative outlook	5 & 6. WA & TAS	Aa2/stable outlook
6. SA	AA/positive outlook		

* Standard & Poor's has placed NSW and Victoria on negative outlook only because it has placed the Commonwealth's AAA rating on negative outlook. S & P has announced that it will not assign a higher rating to any state than the rating it assigns to the Commonwealth.

Sources: State Moody's and Standard & Poor's credit reports for 2015-16.

Table 2: Summing up the States' fiscal performance

	NSW	VIC	QLD	WA	SA	TAS
Position measures:						
1. General government operating balance or surplus	✓	✓	✓	✗	✗	✗
2. Zero or positive general government fiscal balance	✓	✓	✗	✗	✗	✓
3. General government net debt is less than 40% of operating revenue	✓	✓	✓	✗	✓	✓
4. General government net financial liabilities are less than 75% of operating revenue	✗	✗	✓	✗	✗	✗
5. Non-financial public sector net debt is less than 60% of operating revenue	✓	✗	✗	✗	✓	✓
6. Non-financial public sector net financial worth is better than -100% of operating revenue	✗	✗	✗	✗	✗	✗
7. Operating expenses per capita are below the all-state average	✓	✓	✗	✗	✗	✓
8. State public sector employment per capita is below the all-states average	✓	✓	✓	✓	✗	✗
9. Relative tax effort ratio is below 100	✗	✗	✓	✓	✗	✓
10. Relative revenue raising effort ratio is below 100	✓	✓	✗	✓	✗	✓
Score	7/10	6/10	5/10	3/10	2/10	6/10
Trend measures:						
1. General government net operating result has improved	✓	✓	✓	✗	✓	✓
2. General government fiscal balance has improved	✓	✓	✓	✗	✓	✓
3. General government net debt as % of operating revenue has fallen	✓	✓	✓	✗	✓	✓
4. General government net financial liabilities as % of operating revenue has fallen	✗	✓	✓	✗	✓	✗
5. Non-financial public sector net debt as % of operating revenue has fallen	✓	✗	✓	✗	✗	✓
6. Non-financial public sector net financial worth as % of operating revenue has increased (i.e. less negative)	✗	✓	✓	✗	✗	✗
7. Real operating expenses per capita have been flat or falling	✓	✓	✓	✗	✓	✗
8. Number of state public sector employees per capita has been flat or falling	✗	✗	✗	✓	✗	✓
9. Relative tax effort ratio has fallen	✓	✗	✗	✗	✓	✓
10. Relative revenue raising effort ratio has fallen	✓	✗	✓	✗	✗	✗
Score	7/10	6/10	8/10	1/10	6/10	6/10

The problems with reducing all the indicators in Table 2 to a single score are that: the benchmarks are necessarily arbitrary; the indicators are unweighted (whereas some are more important than others); the results say nothing about the degree to which individual states exceed or fall short of benchmarks; the indicators are based on past results and say nothing about the future; and there is some overlap (for example, general government net debt is a component of net financial liabilities). With those caveats in mind, the following conclusions can be drawn from Table 2. The ranking of states according to their fiscal strength in 2015-16 alone is as follows:

1. New South Wales
2. Victoria and Tasmania
4. Queensland
5. Western Australia
6. South Australia

There is nothing surprising in this ranking except the high ranking for Tasmania, which is usually thought to be one of the weakest states — along with South Australia. Tasmania does indeed belong further down the ranking than the raw indicators suggest, because as the smallest and typically slowest growing economy it is less able to service a debt burden of given size than the larger states. Moreover, while its public debt burdens are relatively low, its broader net financial liability burdens are in fact the highest of any state.

The ranking of states according to how their fiscal performance was trending in the three years to 2015-16 is as follows:

1. Queensland
2. New South Wales
3. Victoria, South Australia and Tasmania
6. Western Australia

The following section provides a commentary on the results for each state.

State-by-state summary assessment

New South Wales

Much improved and now top of the class, but must avoid the temptation to rest on its laurels

Strengths:

- Recent solid net operating and overall fiscal surpluses
- Zero general government net debt and low net debt in broader public sector
- Operating expenses well contained
- Large privatisation program being implemented and is politically accepted
- Strong state economy underpins strong finances

Weaknesses:

- Zero net debt is ephemeral: large infrastructure program is driving debt up sharply
- Unfunded public sector superannuation liability makes net financial liabilities high
- Exposure to risk of a slump in property-based revenue

Victoria

Has let its performance slip, but still a solid performer thanks to earlier strengths

Strengths:

- Strengthened net operating and fiscal surpluses in recent years
- Growth of debt burden has ceased
- Operating expenses growth has slowed
- Political willingness to privatise in order to help finance new capital spending
- Strong state economy

Weaknesses:

- Surge in state government employment in recent years may presage weaker spending discipline
- Like NSW, exposure to risk of slump in property market
- High net financial liabilities
- Relative tax burden has edged up

Queensland

Once the unchallenged top of the class, has started to improve from a serious setback, but still has a long way to go

Strengths:

- Operating and fiscal results are much improved.
- Operating expenses were cut sharply to more sustainable level by previous government
- Debt burden has been capped and reduced slightly
- Public sector superannuation is fully funded
- Tax burden remains relatively low
- Potential for economic rebound

Weaknesses:

- Earlier cuts in state government employment are being reversed, which does not bode well for operating costs
- Still running a sizeable overall fiscal deficit.
- Broad public sector debt is still at a high level
- Political unwillingness to privatise state enterprises reduces options for further improvement in state finances
- Some of the recent improvement reflects higher coal prices and royalties, which may not be sustained

Western Australia

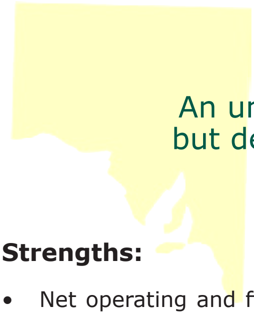
Has gone downhill faster than anyone else in the class and now faces a big task to achieve its potential

Strengths:

- State government employment and operating expenses are being better controlled than previously
- Public sector unfunded superannuation liability is relatively low
- Government is finally beginning to grasp privatisation opportunities
- Potential for a resource-based economic rebound which would strengthen state finances

Weaknesses:

- Large operating and fiscal deficits – only state to record a worsening in recent years
- Debt burden highest of any state
- Much of the work in reducing operating expenses lies ahead and targets may not be realised



South Australia

An underperformer as usual, but deserves credit for trying to lift its game

Strengths:

- Net operating and fiscal deficits have been reduced from previously high levels
- Debt appears to have peaked
- Operating expenses are finally being curbed
- Some taxes have been cut to make SA more competitive

Weaknesses:

- Net debt and net financial liabilities are relatively high
- Operating expenses and taxes remain above average
- Economic outlook is poor
- High dependence on Commonwealth grants reduces budget flexibility

Tasmania

Has lifted its game, but still only fair

Strengths:

- Both general government and broad public sector debt is low
- Operating budget and overall budget close to balance
- Expenses growth has slowed and state employment numbers cut
- Tax burden is relatively low

Weaknesses:

- Very high unfunded public sector superannuation liability and no plans to reduce it
- Limited economic growth prospects
- Heavy dependence on Commonwealth grants limits budget flexibility

Appendix 1:

Glossary of key terms

General government sector: consists of government departments and agencies that provide non-market public services (such as departments of education and regulatory bodies) and are funded mainly through taxes.

Non-financial public sector: consists of the general government sector plus non-financial public corporations, which are trading enterprises that sell goods and services to consumers on a commercial basis and are owned by general government (such as water utilities).

Net debt: the sum of selected financial liabilities (mainly borrowings) less selected financial assets (mainly cash, deposits and investments). Net debt does not include superannuation-related liabilities.

Net financial liabilities: total liabilities less financial assets, but excluding the equity investments in the other sectors of the jurisdiction (e.g. net financial liabilities of the general government sector exclude the government's equity in public corporations). Includes non-debt liabilities such as accrued superannuation and long service leave entitlements, which are substantial for most governments.

Net financial worth: total stock of financial assets less total liabilities.

Operating revenue: transactions that increase net worth of the sector (primarily taxation, property income, sales of goods and services, grants from other sectors).

Operating expense: transactions that reduce net worth of the sector (primarily salaries and other compensation of government employees; consumption of goods and services such as pens, paper, travel and consultant services; depreciation of fixed assets such as roads and school buildings; interest on debt; subsidies and grants to other sectors; and transfer payments to individuals such as pensions).

Net acquisition of non-financial assets: approximately equivalent to capital expenditure on fixed assets such as roads and schools, less sales of existing assets such as public land, less depreciation of fixed assets.

Net operating balance: operating revenue less operating expense.

Fiscal balance or net lending/borrowing: net operating balance less the net acquisition of non-financial assets. A positive result reflects a net lending position and a negative result reflects a net borrowing position.

Appendix 2:

Summary of key aggregates used in this report

	2007	2010	2013	2016	2020
General government gross debt					
Commonwealth ($ billion)					
at face value[6]	53	147	257	418	601
at market value	67	175	301	502	659
States ($ billion)					
at market value	34	67	117	138	173
Total ($ billion)					
at market value	101	242	417	640	832
General government net debt					
Commonwealth ($ billion)	-42	42	154	297	364
as % of revenue[7]	-17.7	17.1	49.4	88.6	84.5
States ($ billion)	-27	1	42	43	89
as % of revenue	-17.7	0.3	20.2	17.6	32.7
Total ($ billion)	-69	43	196	339	453
as % of revenue	-17.7	9.6	37.7	58.8	64.5
General government net financial liabilities					
Commonwealth ($ billion)	n.a.	169	338	590	522
as % of revenue	n.a.	68.6	108.3	176.3	121.2
States ($ billion)	53	134	191	252	249
as % of revenue	34.6	69.0	92.2	103.8	91.6
Total ($ billion)	n.a.	303	529	842	771
as % of revenue	n.a.	68.8	101.9	145.8	109.7
Non-financial public sector gross debt					
Commonwealth ($ billion)	65	173	304	509	n.a.
as % of revenue	26.2	68.5	95.3	147.8	n.a.
States ($ billion)	92	161	232	253	289
as % of revenue	49.6	68.4	92.3	91.3	94.2
Total ($ billion)	157	334	536	762	n.a.
as % of revenue	36.2	68.5	94.0	122.7	n.a.
Non-financial public sector net debt					
Commonwealth ($ billion)	-33	42	156	300	n.a.
as % of revenue	-13.4	16.6	48.8	87.4	n.a.
States ($ billion)	20	83	139	148	204
as % of revenue	10.7	35.2	55.4	53.5	66.5
Total ($ billion)	-14	125	295	449	n.a.
as % of revenue	-3.1	25.6	51.7	72.3	sn.a.

Sources: Commonwealth and State financial reports for 2015-16 and mid-year budget reviews for 2016-17; ABS (Australian Bureau of Statistics), *Government Finance Statistics, Australia, 2014-15*, Cat. No. 5512.0 (Canberra: ABS, 2016).

Endnotes

1 The 'states' as referred to here include the ACT and the NT governments, which perform state-like functions. Local government is excluded.

2 Contingent liabilities are another dimension. They are not included in the analysis in this report, but they are substantial at both the federal and state levels.

3 Scott Morrison, *Speech to the Australasian Finance and Banking Conference*, (Sydney: 14 December 2014).

4 Vito Tanzi, *Pleasant Dreams or Nightmares, in the Public Debts Scenarios?* (Munich: Centre for Economic Studies, 22 January 2016).

5 Simon Cowan, et al. *TARGET30, Reducing the Burden for Future Generations* (Sydney: The Centre for Independent Studies, 2013).

6 Gross debt at face value is subject to the Treasurer's direction, while gross debt at market value is measured more broadly and is the measure used in ABS publications and in most budget tables.

7 For these purposes, Goods and Services Tax (GST) revenue is excluded from Commonwealth revenue as it is earmarked for the states. It cannot be counted twice in the separate calculation of debt/revenue ratios for the Commonwealth and the states.

About the Author

Robert Carling

Robert Carling is a Senior Fellow at the Centre for Independent Studies, where he undertakes research into a wide range of public finance issues and regularly comments in the media on taxation and other budget issues. Before joining the CIS, he was a senior official with the New South Wales Treasury and the Australian Treasury.

THE CENTRE FOR INDEPENDENT STUDIES

Research Report 23 (RR23) • ISSN: 2204-8979 (Printed) 2204-9215 (Online) • ISBN: 978-1-922184-82-5

Published February 2017 by The Centre for Independent Studies Limited. Views expressed are those of the authors and do not necessarily reflect the views of the Centre's staff, advisors, directors or officers.

This publication is available from The Centre for Independent Studies. Visit **www.cis.org.au**.

Level 1, 131 Macquarie St, Sydney NSW 2000 • **phone:** +61 2 9438 4377 • **fax:** +61 2 9439 7310 • **email:** cis@cis.org.au