TARGET30

REDUCING THE BURDEN FOR FUTURE GENERATIONS

States of Debt

Robert Carling

THE CENTRE FOR INDEPENDENT STUDIES

T30.07

National Library of Australia Cataloguing-in-Publication Data:

Carling, Robert G., author.

States of debt / Robert Carling.

9781922184252 (paperback)

Target30 ; T30.07.

Debts, Public--Australia.
Finance, Public--Australia.
Budget deficits--Australia.
Australia--Finance.

Centre for Independent Studies (Australia), issuing body.

336.340994

States of Debt

Robert Carling

THE CENTRE FOR INDEPENDENT STUDIES

T30.07

CIS TARGET30 publications

TARGET30

T30.06 Stephen Kirchner, *Strengthening Australia's Fiscal Institutions* (2013)

T30.05 Simon Cowan (ed.), *Emergency Budget Repair Kit* (2013)

T30.04 Robert Carling, *Shrink Taxation by Shrinking Government!* (2013)

T30.03 Jeremy Sammut, *Saving Medicare But NOT As We Know It* (2013)

T30.02 Andrew Baker, *Tax-Welfare Churn and the Australian Welfare State* (2013)

T30.01 Simon Cowan (ed.), *Towards Smaller Government and Future Prosperity* (2013)

Contents

Table of Figures

Executive Summary

While Commonwealth government debt has been the focus of attention recently, this report takes a broader view by bringing state debt into the picture.

Much has been made of the fact that Commonwealth government debt is projected (under current expenditure and tax policies) to grow from $300 billion at June 2013 to more than $400 billion in 2016–17—and keep growing.

Over the same four years, net debt (after deducting certain financial assets) is expected to grow from $153 billion to $280 billion and then to $325 billion in 2018–19, at which point it will peak as a percentage of GDP.

State debt has also risen dramatically since 2007, when net debt was negative. In the six years to 2013, states added $70 billion to their general government net debt to reach a positive level of $43 billion. Aggregate state debt is manageable at that level, but the upward trend is of concern—and more so in some states than others.

By 2016–17, combined Commonwealth and state general government (GG) net debt will exceed $350 billion—almost 20% of GDP, or more meaningfully, more than 50% of general government revenue.

The general government debt figures do not tell the full story. For the broader non-financial public sector (which includes non-financial public corporations), state net debt was much higher at $127 billion in 2013. Combined with the Commonwealth, total non-financial public sector net debt was $283 billion, already 50% of the sector's revenue. Public corporations' debt is guaranteed by their government owners, but these corporations are better able to carry debt as their investments are supposed to be commercially viable.

The above figures exclude non-debt financial liabilities such as unfunded superannuation and long-service leave liabilities. These loom large in state finances. When added to net debt, non-debt financial liabilities bring the 2013 total of net financial liabilities to $190 billion for state general government and $319 billion for the state non-financial public sector. In most states, general government net financial liabilities in 2013 exceeded 100% of revenue, having increased steeply since 2007.

The states' financial position has deteriorated because their net operating surpluses have shrunk while capital ('infrastructure') spending soared, resulting in large cash deficits. All states have experienced this deterioration: Queensland, Western Australia, South Australia and Tasmania have lost the coveted triple-A credit rating, and NSW and Victoria are at risk of being downgraded should current trends continue.

All states have curbed the growth of operating expenditure, but they will need to persevere in the face of sluggish revenue if they are to rebuild operating surpluses and avoid sharp cuts in capital expenditure.

Introduction

Just how much public debt does Australia have?

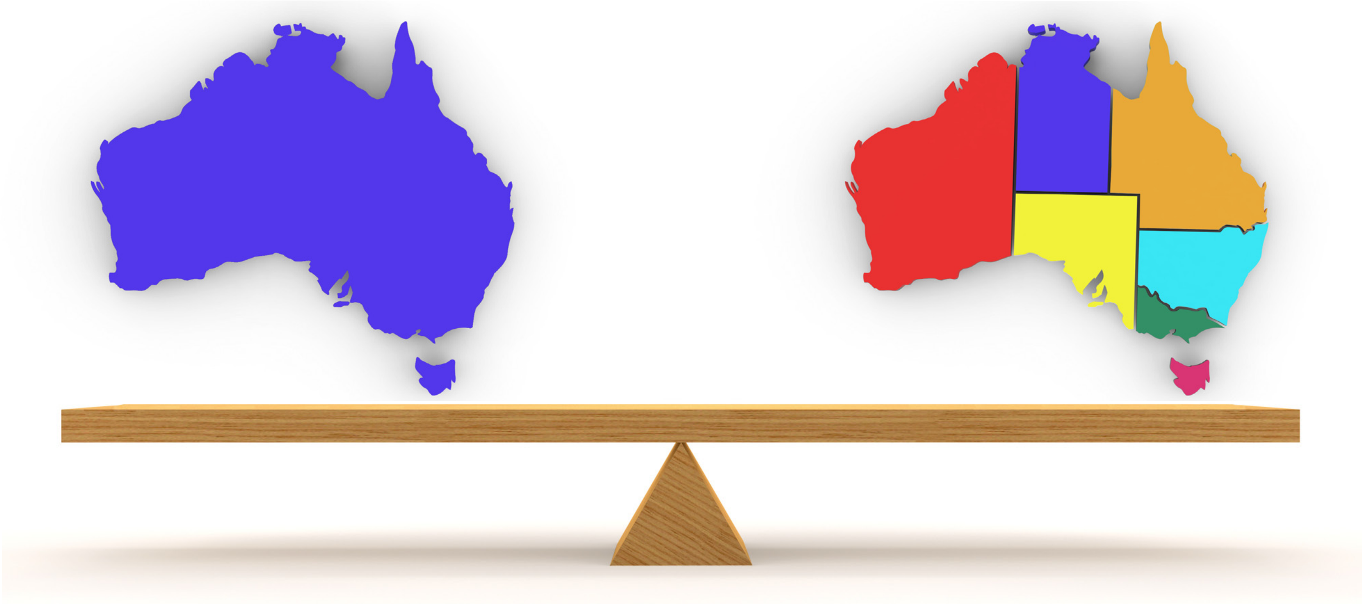
The Commonwealth government's budgetary woes have attracted a lot of attention recently because of the stubbornness of large deficits, rapid growth of debt, and the newly elected government's focus on these issues. But the states' fiscal health should also be a focus of attention because their debt levels also have risen sharply. This report turns the spotlight onto our second tier of government and asks how well or badly the states are performing financially, and how much larger the national public debt becomes when the states' debts are included.[1]

The report is in two parts. The first part examines recent trends for all states in aggregates such as deficits, debt, revenue and expenditure, and makes comparisons with the Commonwealth. The second part—which updates my 2011 report *Tax, Borrow, Spend: How the States Compare*[2]—looks at the comparative fiscal management record of each state. 'Fiscal management' covers dimensions such as accumulated debt burdens and their rate of growth or contraction, the level and growth of government spending, the size of the government workforce, the level of the tax burden, and the trend of tax policy towards more or less taxation.

Sound fiscal management isn't everything we should expect of government, but it is an essential platform for efficient delivery of quality public services and a stable, attractive climate for private investment. If fiscal management goes off the rails, everything else government does is eventually compromised.

This report uses a number of terms drawn from government finance statistics. In case their meanings are unclear to readers, a glossary of key terms is provided in Appendix 1.

Appendix 2 brings together many of the figures discussed in the text.



Part 1: Overview

The build-up of federal government debt in recent years and projections that it will exceed $400 billion by 2016–17 have been well publicised. As recently as 2008–09, federal debt was less than $100 billion. This way of portraying the public debt load and its increase does, however, overstate and understate its full dimensions: It overstates by omitting financial assets, and it understates because it excludes non-debt liabilities and other levels of government.[3]

For what the medium-term estimates are worth, federal debt net of financial assets is projected to rise to around $325 billion in 2018–19, at which level it will peak as a proportion of gross domestic product (GDP) at 16%—below its previous peak in 1995–96—and then begin to decline relative to GDP (but not in absolute terms).[4] As a percentage of annual federal revenue, net debt will peak at more than 70%. Were these projections to be realised, the federal debt load would be manageable—which is not to say it should be allowed to reach that level considering the medium-term risks and the certainty of increasing pressure on federal finances in the long term.[5]

The bigger question is what the debt load becomes when the states are brought into the picture. The CIS has advocated—for example, in its TARGET30 campaign—a broad view of the public sector, not just the part represented by the federal government.[6] The states are different governments, but the cost of servicing their debts falls on the same households and businesses that, as taxpayers, are expected ultimately to service federal debt. Should we be concerned about the magnitude of state debt? Even if the federal debt is manageable, does this assessment change once state debt is added?

Spotlight on state debt

The states have been falling deeper into debt at the same time as the federal government.

Gross debt on issue by all states and territories combined for their general government (GG) sectors was $97 billion in June 2012, and the corresponding figure for the Commonwealth was $280 billion, making a total of $377 billion. On the broader definition of the non-financial public sector, the states and the Commonwealth were indebted in the sums of $197 billion and $282 billion, respectively, for a total of $479 billion. June 2012 was the last compilation date for ABS figures.[7] These magnitudes have undoubtedly risen further since then, and will continue to do so for the foreseeable future. Like the Commonwealth, however, the states hold financial assets, and it is more meaningful to examine their debts net of those assets.

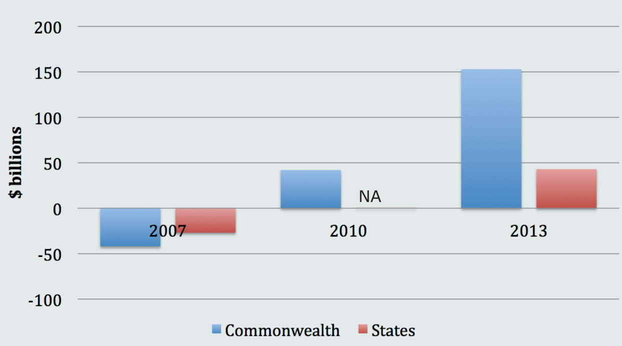
The following figures illustrate various measures of net debt and net financial liabilities at three points in recent history, and provide comparisons of the states in aggregate with the federal government. The three points are June 2007 (before the beginning of the global financial crisis), June 2010 (after the worst of the crisis and the bulk of the Commonwealth's fiscal stimulus), and June 2013 (the latest actual observation point).[8]

(a) Net debt of the general government (GG) sector

The narrowest measure of net debt is that for the general government sector, which includes the non-commercial activities of government departments and authorities but excludes governments' commercial and financing arms. Total state net debt before the global financial crisis was negative, like that of the Commonwealth (Figure 1). By 2010, state net debt was close to zero and by 2013 it had risen to $43 billion—a deterioration of $70 billion in six years. This was substantial, but less than the deterioration of $182 billion in federal general government net debt in the same period to $153 billion at June 2013.

Absolute dollar amounts can be eye-catching but don't mean much on their own. More meaningfully, state net debt in June 2013 was around 3% of GDP, compared

Figure 1: General government net debt of federal and aggregated state and territory governments



Sources: Federal and state government financial reports for 2012–13; ABS (Australian Bureau of Statistics), *Government Finance Statistics, Australia, 2011–12,* Cat. No. 5512.0 (Canberra: ABS, 2013).

with 10% for the Commonwealth, making for a total of 13% of GDP. It is even more telling to express net debt in relation to the flow of revenue from which the debt must be serviced. On this basis, state debt stood at about 21% of general government operating revenue, which suggests that in aggregate state net debt at that time was sustainable. (Whether that will continue to be the case, and whether it is true for each state individually, is the subject of further discussion below.) Federal net debt as a proportion of revenue was more than double the state figure, at around 49%.[9] For the two levels of government combined, the figure was about 38%.

(b) Net debt of the non-financial public sector (NFPS)

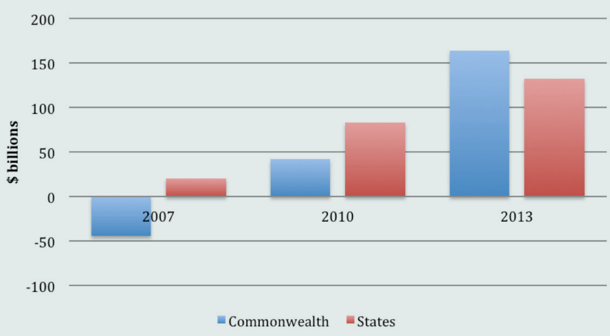
The general government sector, as noted above, excludes the commercial activities of government, such as water and power utilities and ports. While some of these have been privatised, their presence continues to loom large in state finances. As Figure 2 illustrates, state non-financial public sector (NFPS) net debt rose to $127 billion in June 2013, up by $107 billion since 2007.

Reflecting the relatively larger scale of state government trading enterprises, state NFPS net debt was much larger as a proportion of the Commonwealth figure than was the case for general government net debt. State NFPS net debt was also much larger in relation to operating revenue—at around 50%—than was general government net debt.

Whether the higher level of state net debt in the NFPS is of concern hinges on whether the associated investments by government commercial enterprises will generate sufficient returns to service and repay the debt. A more tolerant view can be taken of debt based on genuinely commercial investment and financing decisions, but in considering the potential burden on taxpayers it is well to remember that the debt of public trading enterprises is guaranteed by governments.

The combined federal and state NFPS net debt was around $280 billion at June 2013, equivalent to 19% of GDP and almost 50% of NFPS operating revenue.

Figure 2: Net debt of non-financial public sectors

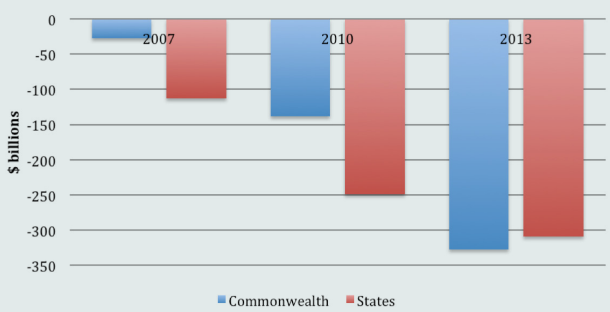


Sources: Federal and state government financial reports for 2012–13; ABS (Australian Bureau of Statistics), *Government Finance Statistics, Australia, 2011–12,* Cat. No. 5512.0 (Canberra: ABS, 2013).

(c) Net financial worth (NFW) of the NFPS

The broadest measure of the public sector's financial health is provided by net financial worth (NFW). The main difference—and a large one—is that NFW includes the unfunded superannuation liabilities in relation to public sector employees. For all states and territories combined, NFW of the non-financial public sector was negative $310 billion at June 2013, or $180 billion more than net debt (Figure 3). Negative NFW in 2013 was more than double the figure of 2007, and slightly larger in the Commonwealth sector.

Figure 3: Net financial worth of non-financial public sectors



Sources: Federal and state government financial reports for 2012–13; ABS (Australian Bureau of Statistics), *Government Finance Statistics, Australia, 2011–12,* Cat. No. 5512.0 (Canberra: ABS, 2013).

Why has state debt been rising?

Even on the narrowest definition—general government sector net debt—the combined financial position of the states and territories has worsened by $70 billion in the six years to 2013. Yet the states say they are either in surplus or close to it. How can this be?

The explanation is that the surpluses the states refer to are defined as net operating surpluses, which do not take into account net capital expenditure. As Figure 4 illustrates, operating surpluses have dwindled while capital expenditure has soared, resulting in rising cash deficits. Cash results, not operating results, are what drive the need for debt financing.

In aggregate, the states' financial strength peaked in 2006/07 after several years of large operating and cash surpluses, low levels of capital ('infrastructure') spending, and dwindling debt. Operating expenses had been growing strongly, but so too had revenue.

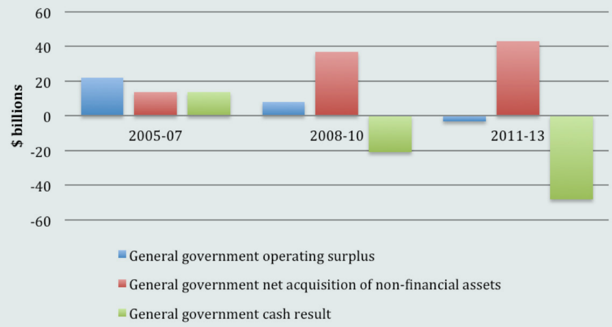
Since 2006/07, state fiscal aggregates have deteriorated, but the trends are clearer if the period is divided into two.

The three years to 2009/10 represented the impact of the global financial crisis, when tax revenue and investment income sagged. However, the states maintained strong growth in operating expenditure and ramped up capital expenditure, supported by large increases in federal grants associated with the fiscal stimulus response to the global financial crisis. The states' operating surpluses shrank, and being insufficient to finance greatly increased levels of capital expenditure, the cash bottom line went into the red and debt increased.

Since 2009/10, operating surpluses in aggregate have dried up and cash deficits have risen further. From a negligible level at 30 June 2010, total general government net debt rose to around $43 billion at June 2013. Cash deficits have remained high partly because capital expenditure remained high, and partly because operating revenue slowed at a faster rate than states' efforts to curb the growth of operating expenses. Figure 5 illustrates this point.

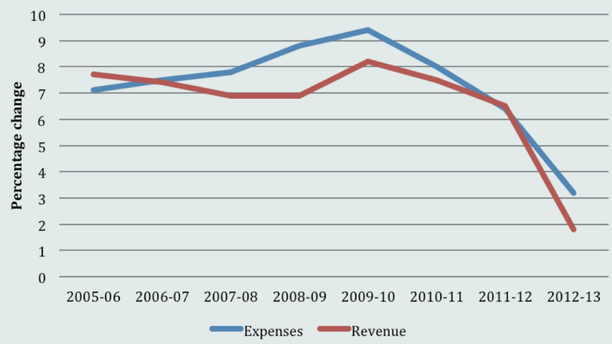
The large increase in capital expenditure on items such as roads, public transport, hospitals and schools is welcome insofar as it addresses genuine infrastructure deficiencies. The problem from a financing perspective is that this increase coincided with a dramatic decline in operating surpluses, leading to greatly increased reliance on debt financing. While current state debt levels are generally consistent with fiscal sustainability, they will not remain so if the upward trend is allowed to continue.

Figure 4: States' transition from surplus to deficit (aggregate), 2007–13



Sources: Federal and state government financial reports for 2012–13; ABS (Australian Bureau of Statistics), *Government Finance Statistics, Australia, 2011–12,* Cat. No. 5512.0 (Canberra: ABS, 2013).

Figure 5: States' three-year moving average growth in operating revenue and expenses (% pa)



Sources: Federal and state government financial reports for 2012–13; ABS (Australian Bureau of Statistics), *Government Finance Statistics, Australia, 2011–12,* Cat. No. 5512.0 (Canberra: ABS, 2013).

Will state debt continue to rise?

Halting the growth in state net debt requires a large reduction in capital expenditure, a large increase in operating surpluses, or some combination.

Capital expenditure has peaked and is likely to decline as current projects are completed. This will help reduce borrowing needs. The pressure on states to maintain and upgrade infrastructure is, however, unlikely to allow a retreat in capital expenditure back to the low levels typical before 2007.

As far as operating surpluses are concerned, revenue growth is likely to trend upwards as key sources of state revenue such as the GST (consumer spending), payroll tax (employment and wages), stamp duty and land tax (housing markets), and royalties (mining activity) strengthen. However, just as the prospects for federal revenue growth have been revised down repeatedly, the prospects for state revenue have been marked down and there is no reason to expect more than a mild recovery.

The subdued revenue outlook underscores the importance of continued curbs on operating expenditure, which would allow operating surpluses gradually to rebuild and help limit the need for cutbacks in capital expenditure. At the state level, curbing operating expenditure requires above all keeping a lid on government payrolls (both staff numbers and pay rates) and avoiding costly new program commitments, while continually searching for ways to improve efficiency and effectiveness in delivery of existing programs.

In the long term, states will share with the Commonwealth the brunt of the fiscal costs of an ageing population. Just how much of this falls to the states will depend on how much of the increased health care bill will be borne by the Commonwealth and how much is left with the states.

The Productivity Commission in 2013 estimated a total fiscal gap of 5.9% of GDP after 50 years, of which 1.4 percentage points would accrue in state budgets.[10] In 2013, the NSW Treasury put the long-term fiscal gap for that state at 1.5% of GDP.[11] These figures clearly suggest that unless action is taken to control the fiscal costs of ageing, state governments, like the Commonwealth, will face rising deficits and debt in the long run.

Part 2: Comparative performance of individual states

To gauge the comparative performance of individual states, this report considers various indicators of debt and other financial liabilities, spending and taxation policies. The report examines both their recorded positions at June 2013 and the trend over the three years to June 2013.

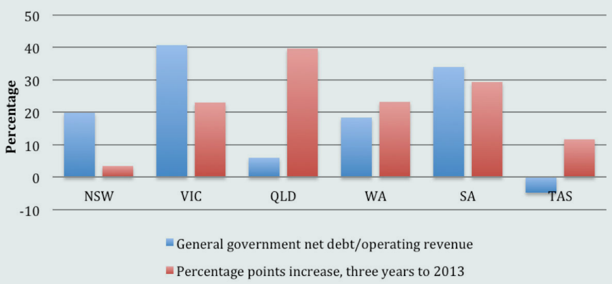
Indicators of debt and other financial liabilities

(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 financial guidelines is that general government net debt should not exceed 50% 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 6 compares the six states' ratios of general government net debt to operating revenue at June 2013 and the change in the three years to June 2013.

Figure 6: States' general government net debt as a percentage of operating revenue, 2013



Sources: State financial reports for 2012–13; ABS (Australian Bureau of Statistics), *Government Finance Statistics, Australia, 2011–12,* Cat. No. 5512.0 (Canberra: ABS, 2013).

Each state has recorded an increase in its general government net debt burden in the three years to June 2013, with the largest increases in Queensland and South Australia and the smallest in NSW. The deterioration reflects the cash deficits run by the states in those years, but the correspondence is imprecise because other cash transactions, such as privatisation of government entities, can also affect the borrowing requirement. (The increase in debt in NSW has been ameliorated by privatisation proceeds in recent years.)

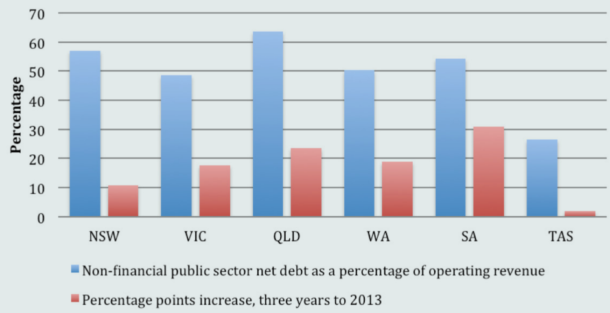
Levels of net debt as a proportion of revenue varied widely at June 2013, with Victoria and South Australia the highest, and Queensland and Tasmania the lowest. In no state, however, did the proportion exceed the 50% guideline referred to above.

(b) 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. Queensland, South Australia and NSW have the highest debt burdens on this measure, and Tasmania the lowest, with the other states close to the 50% mark (Figure 7). All states reported increases in the three years to June 2013, with Queensland and South Australia the largest and NSW and Tasmania the smallest.

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. At June 2013, Queensland was clearly above this level; NSW and South Australia were very close to it; while Victoria, Western Australia and Tasmania were below it.

Figure 7: States' non-financial public sector net debt as a percentage of operating revenue, 2013



Sources: State financial reports for 2012–13; ABS (Australian Bureau of Statistics), *Government Finance Statistics, Australia, 2011–12*, Cat. No. 5512.0 (Canberra: ABS, 2013).

(c) 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 a combination of poor investment returns, reduced discount rates for future liabilities, and increased expected longevity of defined benefit scheme members.

General government sector NFL is above 100% of revenue in four states, with only Queensland and Western Australia below that level. South Australia and Tasmania have the highest such ratios (Figure 8).

Figure 8: States' general government net financial liabilities as a percentage of operating revenue, 2013

Sources: State financial reports for 2012–13; ABS (Australian Bureau of Statistics), *Government Finance Statistics, Australia, 2011–12,* Cat. No. 5512.0 (Canberra: ABS, 2013).

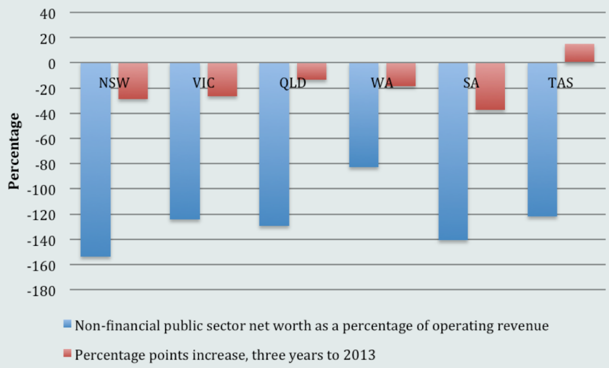
As also shown in Figure 8, the NFL burden rose in all states in the three years to 2013, with the largest increases in Queensland, South Australia and Tasmania, and the smallest in NSW.

(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 (NFPS). Relating this to NFPS revenue, Figure 9 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. However, in all states it has gone dramatically further into the red since then, now exceeding 120% of revenue in all states except Western Australia, where it is still below 100%. NSW and South Australia have the highest negative readings, and the largest deterioration in the three years to 2013 was in South Australia.

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 9: States' non-financial public sector net financial worth as a percentage of operating revenue, 2013



Sources: State financial reports for 2012–13; ABS (Australian Bureau of Statistics), *Government Finance Statistics, Australia, 2011–12,* Cat. No. 5512.0 (Canberra: ABS, 2013).

Indicators of spending

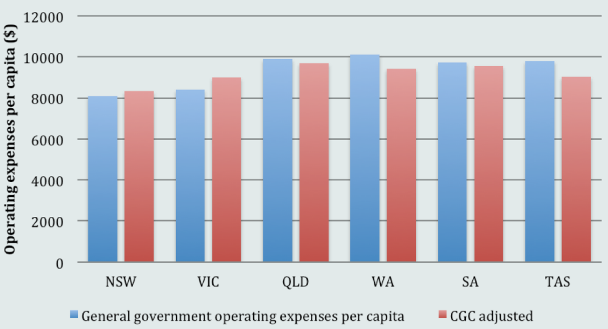
Expenditure policies are among the key determinants of states' public sector financial strength or weakness. Here we examine levels of and trends in operating expenses and state government employment.

(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 10). Queensland, Western Australia and South Australia were clearly above the average, while NSW was clearly below it.

Without the CGC adjustment noted above, the dispersion of per capita expenses among the states is even larger, from around $8,000 in NSW to around $10,000 in Queensland and Western Australia.

Figure 10: States' general government operating expenses per capita, 2012–13



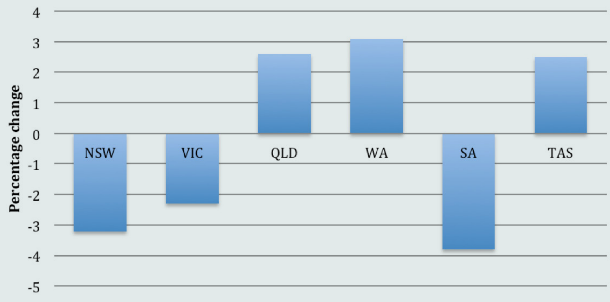
Sources: State Financial Reports for 2012–13; CGC (Commonwealth Grants Commission), *Report on GST Revenue Sharing Relativities, 2013* (CGC: Canberra, 2013).

(b) Growth in real per capita expenses

Comparative growth in general government expenses is best assessed after adjustment for population growth and inflation. Figure 11 shows the growth in real per capita expenses in each state in the most recent three years. Clearly there has been a dramatic slowdown in every state, such that in the most recent three years real per capita spending contracted in NSW, Victoria and South Australia. The slowdown was much needed to match the slowdown in states' revenue and prevent even larger increases in debt than actually occurred. However, Queensland, Western Australia and Tasmania still recorded growth in expenses even after stripping out inflation and population growth.

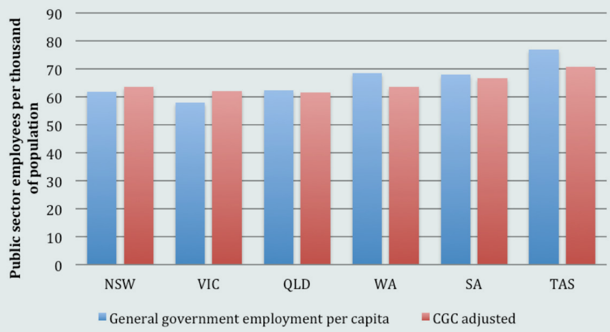
As payroll is by far the largest expense of state governments, it is important to focus on levels and trends in the number of state public sector employees. The number per 1,000 of population is shown in Figure 12, along with an adjusted figure that incorporates the CGC adjustment described above for per capita expenses. On average, states employed around 65 people per 1,000 of population in June 2013. Both with and without the CGC adjustment, South Australia and Tasmania were well above the average.

Figure 11: Percentage change in real per capita operating expenses for each state, three years to 2012–13



Source: ABS (Australian Bureau of Statistics), *Government Finance Statistics, Australia, 2011–12,* Cat. No. 5512.0; *Consumer Price Index, Australia, December 2013*, Cat. No. 6401.0; *Australian Demographic Statistics, June 2013*, Cat. No. 3101.0 (Canberra: ABS, 2013); State financial reports for 2012–13.

Figure 12: States' general government public sector employees per thousand of population, June 2013



Source: ABS (Australian Bureau of Statistics), *Employment and Earnings, Public Sector, Australia, 2012–13*, Cat. No. 6248.0.55.002.

(c) Growth in state public sector employees

For purposes of comparison, the growth in state public sector employees is best adjusted for population growth. Figure 13 shows the results for the latest three years. As with expenses, the growth in state employment has slowed markedly from quite rapid growth in the preceding three years to June 2010. In Queensland, Western Australia and Tasmania, there were absolute declines in employment per 1,000 of population in the three years to June 2013.

Figure 13: Percentage increase in government employment per capita for each state, three years to June 2013

Sources: ABS (Australian Bureau of Statistics), *Employment and Earnings, Public Sector, Australia, 2012–13*, Cat. No. 6248.0.55.002.

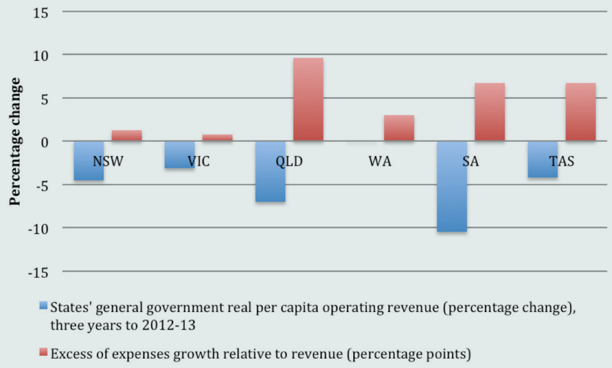
Revenue indicators

(a) Growth in real per capita operating revenue

One of the outstanding features of state finances in recent years has been the weakness of budget revenues. As Figure 14 shows, every state except Western Australia experienced a decline in real per capita operating revenue in the three years to 2012–13, and in Western Australia there was no discernible increase. The weakness in revenue was not generally a result of the states cutting taxes—to the contrary—but of weakness in revenue bases and a decline in Commonwealth grants from the abnormally high level of 2009–10 associated with fiscal stimulus disbursements to the states. It was essential for the states to curtail operating expenses—which they have done (see above)—but they have not matched the slowdown in revenue. In every state, real per capita expenses declined by less (or rose by more) than real per capita operating revenue. Figure 14 also shows the size of these negative gaps between revenue and expenditure growth, which were especially large in Queensland, South Australia and Tasmania.

Looking ahead, real per capita revenue is not likely to decline as much as in the last three years, and may well increase, but it is unlikely to increase as much as in the pre-GFC times. This underscores the importance of exercising ongoing restraint in operating expenditure in all states, with the growth in expenses preferably being kept below the growth in revenue for some years to restore state finances to better health.

Figure 14: States' general government real per capita operating revenue (percentage change), three years to 2012–13



Sources: State financial reports for 2012–13; ABS (Australian Bureau of Statistics), *Government Finance Statistics, Australia, 2011–12,* Cat. No. 5512.0 (Canberra: ABS, 2013).

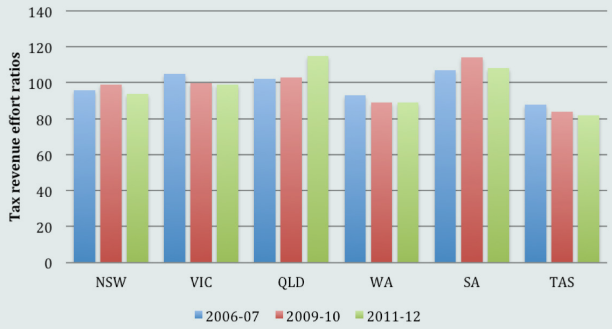
Figure 15: Tax effort ratio in each state, 2007–12

(b) Relative weight of state tax burdens

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 15, along with total revenue effort ratios in Figure 16.

The indicators displayed in figures 15 and 16 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. With respect to tax effort, the four smaller states stand out, with Queensland, Western Australia and Tasmania well below average and South Australia well above average. Combined with their deteriorating financial ratios, this suggests that Queensland, Western Australia and Tasmania are not raising enough taxation to finance their chosen levels of expenditure, while South Australia's financial position has worsened *despite* that state's relatively high taxes.

Figure 16: Total revenue raising effort ratio in each state, 2007–12



Source: CGC (Commonwealth Grants Commission), *Report on GST Revenue Sharing Relativities, 2013* (CGC: Canberra, 2013).

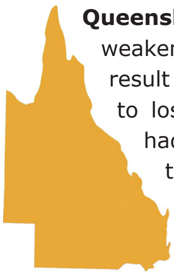
Note: A reading of 100 represents an average tax or revenue raising effort.

The total revenue effort ratios in Figure 16 tell a similar story, except that Queensland becomes an above-average revenue raiser, in part because of its high coal royalty rates which are not reflected in the tax effort ratios.

State-by-state summary assessment

New South Wales has a relatively low general government net debt burden but its net financial liabilities are much higher, as is net debt in the broader public sector. The general government net operating result has been weak for several years and is not contributing to financing the greatly increased capital program. The previous and current governments have used privatisation proceeds to alleviate the resulting growth in debt, but this does not fix the underlying problem of excessive growth in operating expenditure relative to revenue. Meanwhile, the severity of NSW state taxation is above the all-states average. The current government has acted to curb the growth in operating expenditure and the early fruits of that effort can be seen, but it will need to continue for years if an operating surplus is to be rebuilt. This is why NSW has been put on notice that it only marginally remains a triple-A credit.

Victoria has retained its triple-A credit rating with a little more margin of safety than NSW, but the trend in its debt burden in recent years has been more adverse and will eventually catch up with NSW if it continues. The saving grace for Victoria is that it has managed to keep the net operating result marginally in surplus with an average tax and revenue raising effort. Having been an early mover on the privatisation front, it has fewer government trading enterprises left to privatise, but that also means that it carries a lower level of non-financial public sector net debt. Like NSW, Victoria has reduced real per capita operating expenses in recent years but will need to continue on this path in the face of subdued revenue.



Queensland has seen the most dramatic weakening in state finances since 2007, as a result of which it was the first of four states to lose the triple-A credit rating. Queensland had traditionally been a low spending/low taxing state, but the Labor governments in office after 1997 ramped up operating expenditure to levels more like the other states and embarked on a large capital program to improve infrastructure in the context of strong population growth. This left the state exposed when it experienced a steep decline in revenue after 2007. It continues to struggle with a large operating deficit. The new government in 2012 has taken a much stronger approach to curbing operating expenditure and the capital program is moderating as projects are completed. However, the financial benefits of these changes are yet to show up in the three-year trends, which still show growth in real per capita operating expenses and increases in debt burdens that are among the largest of all the states. A continuation of current fiscal policies should see financial ratios stabilise soon, but Queensland remains a long way from regaining its triple-A status.

Western Australia's finances have deteriorated in a similar fashion to Queensland, but the decline started a few years later. Rampant growth in real per capita operating expenditure and a greatly increased capital program in the context of strong population growth took their toll as strong real revenue growth came to a halt in the three years to 2012–13. Western Australia recorded the largest increase in real per capita operating expenditure in those three years and the increase in its debt ratios was among the largest. Thus in 2013 Western Australia became the fourth state to lose its triple-A rating. The state government has increased a range of taxes from relatively low levels, but the key to halting the deterioration in its finances is tighter control of operating expenditure.

South Australia's financial position is in some respects the weakest of the six states. It has one of the highest debt ratios, recorded the largest increase in debt in the three years to 2013, and has one of the least dynamic economies. Stronger trend growth in the state economy would make the current debt burden more manageable, but South Australia suffers a bleak outlook for growth. It is not surprising that the state lost its triple-A rating in 2012. South Australia has the highest level of state taxation. The government has cut real per capita operating expenditure but it has also experienced one of the steepest falls in revenue. More needs to be done to curb operating expenses. But South Australia also needs policies that will attract more private investment, lead to greater economic diversification, and spark higher trend growth rates.

Tasmania has a 'basket case' reputation, but in fact it does not have the highest net debt ratios, nor has it chalked up the largest increase in debt in recent years. It does, however, have the second highest level of general government net financial liabilities. Tasmania lost its triple-A credit rating in 2012.[12] The state's problem is its narrow economic base and lack of trend growth, which renders it less able to carry each dollar of debt than other states. The public sector is large in relation to the economy, with state public sector employees per capita remaining the most numerous of all the states despite some trimming of their numbers in recent years. Real per capita operating expenses have continued to grow at a substantial rate. Like South Australia, but even more so, Tasmania needs a bigger private sector, more economic diversification, and more growth.

Appendix 1:
Glossary of key terms

Some of the precise definitions of the concepts used in this report are highly technical. The technicalities are unnecessary for an understanding of the report. The following definitions are designed to help the lay reader understand the 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.

Cash surplus/deficit: net cash inflow from operating activities (cash from operating revenue less cash to operating expenses) less net cash outflow from investments in non-financial assets (cash on purchases of fixed assets less cash from sales of fixed assets).

Appendix 2:
Summary of key aggregates used in report

	2007	2010	2013	2017	2019
General government gross debt ($ billion)					
Commonwealth	67.3	174.9	300.6	470	520
States	33.9	66.8	116.6	145	n.a.
Total	101.2	241.7	417.2	615	n.a.
General government net debt					
Commonwealth ($ billion)	-30.8	42.0	153.0	280	325
as % of revenue	-13	17	49	73	
States ($ billion)	-27.2	0.5	43.0	72	
as % of revenue	-18	0	21	29	
Total ($ billion)	-58.0	42.5	196.0	352	
as % of revenue	-15	10	38	56	
General government net financial liabilities					
Commonwealth ($ billion)	n.a.	168.8	337.8	414	
as % of revenue	n.a.	69	109	108	
States ($ billion)	53.2	134.3	191.4	198	
as % of revenue	35	69	91	80	
Total ($ billion)	n.a.	303.1	529.2	611.9	
as % of revenue	n.a.	69	102	97	
Non-financial public sector net debt					
Commonwealth ($ billion)	-33.3	41.7	155.8	n.a.	
as % of revenue	-13	17	49	n.a.	
States ($ billion)	20.7	83.9	127.3	188.1	
as % of revenue	11	36	49	61	
Total ($ billion)	-12.6	125.6	283.1	n.a.	
as % of revenue	-3	26	49	n.a.	

Sources: Commonwealth and State budget documents and mid-year budget reviews for 2013–14; ABS (Australian Bureau of Statistics), *Government Finance Statistics, Australia, 2011–12,* Cat. No. 5512.0 (Canberra: ABS, 2013).

TARGET30

REDUCING THE BURDEN FOR FUTURE GENERATIONS

Endnotes

1 The 'states' as referred to here include the ACT and the NT governments, which perform state-like functions. Local government is excluded, as (in aggregate) is has negative net debt and positive net financial worth.

2 Robert Carling, *Tax, Borrow, Spend: How the States Compare,* Issue Analysis 124 (Sydney: The Centre for Independent Studies, 2011).

3 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.

4 *Mid-Year Economic and Fiscal Outlook* (Government of Australia, December 2013).

5 *Intergenerational Report 2010* (Australian Treasury, February 2010).

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

7 ABS (Australian Bureau of Statistics), *Government Finance Statistics, Australia, 2011–12,* Cat. No. 5512.0 (Canberra: ABS, 2013).

8 The June 2013 figures are based not on ABS compilations, which are not yet available, but on Commonwealth and state government final budget outcome reports for 2012–13.

9 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.

10 *An Ageing Australia: Preparing for the Future*, Productivity Commission Research Paper, 11/2013 (Canberra: Productivity Commission, 2013).

11 NSW Budget Papers, 2013.

12 Moody's rating agency downgraded Tasmania from triple-A to the second top level. Standard and Poor's also assigns Tasmania its second top rating but as it had never assigned triple-A to Tasmania there was no downgrade by Standard and Poor's.

Author

Robert Carling is a Senior Fellow at The Centre for Independent Studies. 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 NSW Treasury and in that role was responsible for advising the state government on taxation policy and federal/state financial relations. Prior to that he was a senior official with the Australian Treasury in Canberra, and both the World Bank and the International Monetary Fund in Washington, D.C.

Acknowledgement

I am grateful to Harry Stutchbury for research assistance in the preparation of this report.
However, any errors or omissions remain the author's responsibility.

THE CENTRE FOR INDEPENDENT STUDIES

CIS TARGET30 • T30.07 • ISSN Print: 2201-7615 • ISSN Online: 2202-3240 • ISBN: 978 1 922184 25 2
Published March 2014 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.
PO Box 92, St Leonards, NSW 1590 Australia • **p:** +61 2 9438 4377 **f:** +61 2 9439 7310 **e:** cis@cis.org.au