State finances at the crossroads:

The states' budget problem, and what to do about it

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Executive summary

- The economic and fiscal performance of the states has a significant impact on Australia's economic fortunes now and in the future. With taxing, spending and financial management policies and strategies at its disposal, state activities have a critical impact on the economy.
- The taxing and spending approaches by the states have dragged down Australia's economic performance in recent years and, if left unaddressed, could hamper the nation's recovery from the looming recession.
- It is forecast that the states will reach a total budget deficit of $10 billion this coming financial year, with borrowings to grow to $81 billion by 2011-12.
- The fiscal situation facing the states is a product of past policy events. State and territory governments have been the beneficiaries of a revenue windfall of record proportions, with taxes and grants delivering $167 billion in revenue from 2000-01 to 2007-08 above what they originally forecast.
- Armed with windfall revenues, the states have engaged in spending of $987 billion over the same period. Not to be outdone, actual spending was $157 billion over the initial forecasts published by the states.
- The Australian states used taxpayers' money to create boom conditions for bureaucrats, with much recurrent spending directed towards hiring public sector employees and increasing their wages.
- Money spent by governments appears to have delivered only mixed performance outcomes in key areas of service delivery.
- After nearly a decade of budgetary plenty, which saw state budget surpluses reach a height of 0.8 per cent of GDP by 2005-06, governments are now facing crippling budget deficits and rising public debt.
- States are eager to blame their budget woes on Wall Street. The reality is that the 'spend quickly for today' approach by the states has driven the worsening outcomes.
- Reforms must be implemented to eliminate structural budget deficits and bring the fiscal houses of the states back into order.
- Budgets can be repaired by cutting inefficient state taxes, making spending more focused on core services, and enforcing strong fiscal responsibility rules.
- The preparedness of states and territories to turn their backs on their big-spending ways should be the criterion by which their 2009-10 budgets are judged.

Section One

The impact of the states on national economic performance

The activities of state governments[1] have a profound impact on the national economy. Spending by state governments - $155 billion in 2007-08 – is the equivalent of 14 per cent of national GDP.

In the wake of the ructions in global financial markets much of the media and policy focus has been on the budgetary decisions of the federal government. Relatively little attention has been devoted to state governments. But state governments retain significant influence over economic growth and productivity – through their taxing, spending and fiscal management. If these policy levers have been mismanaged, as has been the case in recent times, the states can hamper the ability of the national economy to recover from the recession.

State government budget deficits

On the basis of the latest published estimates, the aggregate state and territory government deficit is expected to be in the order of $1.2 billion in 2008-09. The total deficit of all state budgets could be as high as $10 billion by 2010-11 (this compares to a potential federal budget deficit for 2009-10 of $50 billion).[2]

This is a far cry from the aggregate state budget surpluses of $8 billion in 2005-06, and reflects a significant deterioration in the fiscal sustainability of state government operations.

State government debt

Whilst Western Australia, South Australia and Tasmania continued to reduce their borrowings from 2000-01 to 2007-08, other jurisdictions reversed their previous fiscal strategy of the 1990s to, in some cases, dramatically increase their general government borrowing (Figure 1). With state governments now embarking on capital works programs financed by debt, the amount of borrowings can be expected to dramatically increase.

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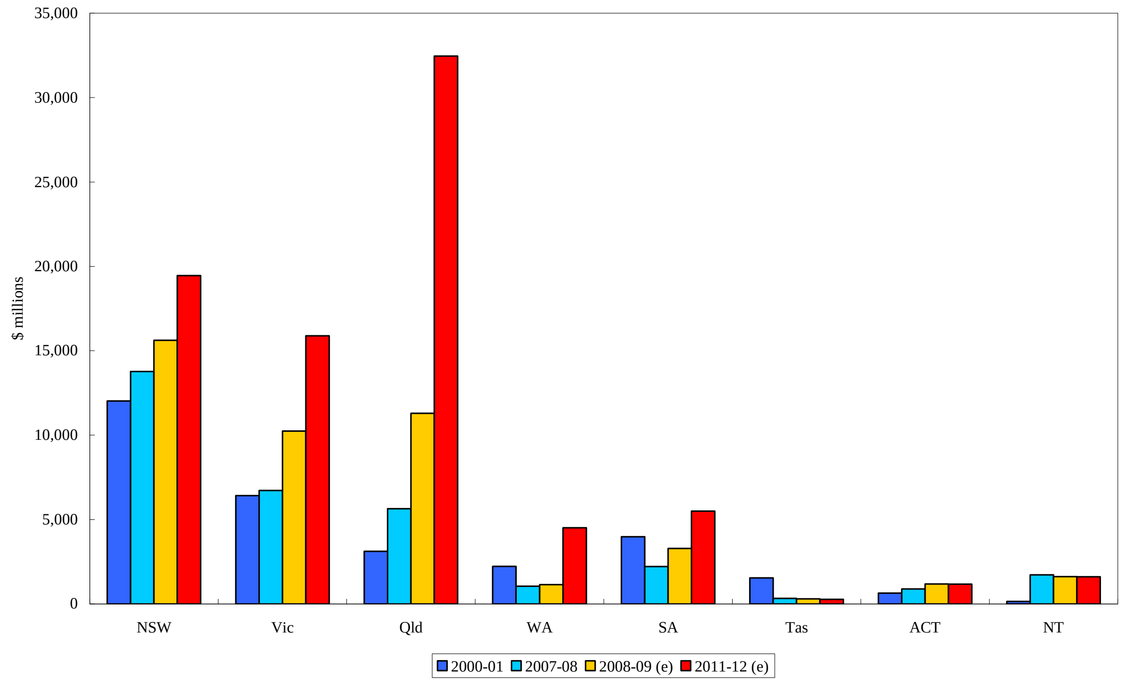
[1] References to ‘states’ include the Australian states and territories.
[2] Peter Martin, 2009, ‘‘Tough calls’ on budget as deficit for $50bn’, The Age, 28 April.

Figure 1: State general government sector borrowing, 2000-01 to 2011-12



Source: State and territory government budget papers.

Taking into account the asset holdings of governments, the consequence of this spike in borrowing is that the states' general government net debt will increase (Table 1). After a sustained effort to reduce net debt – to the point of achieving negative net debt outcomes – it is expected that jurisdictions will once again have growing net debt on their balance sheets over the next few years. The level of net debt incurred by jurisdictions is significantly higher when taking into account the borrowings of government trading enterprises.

Table 1: State net debt, 2000-01 to 2011-12

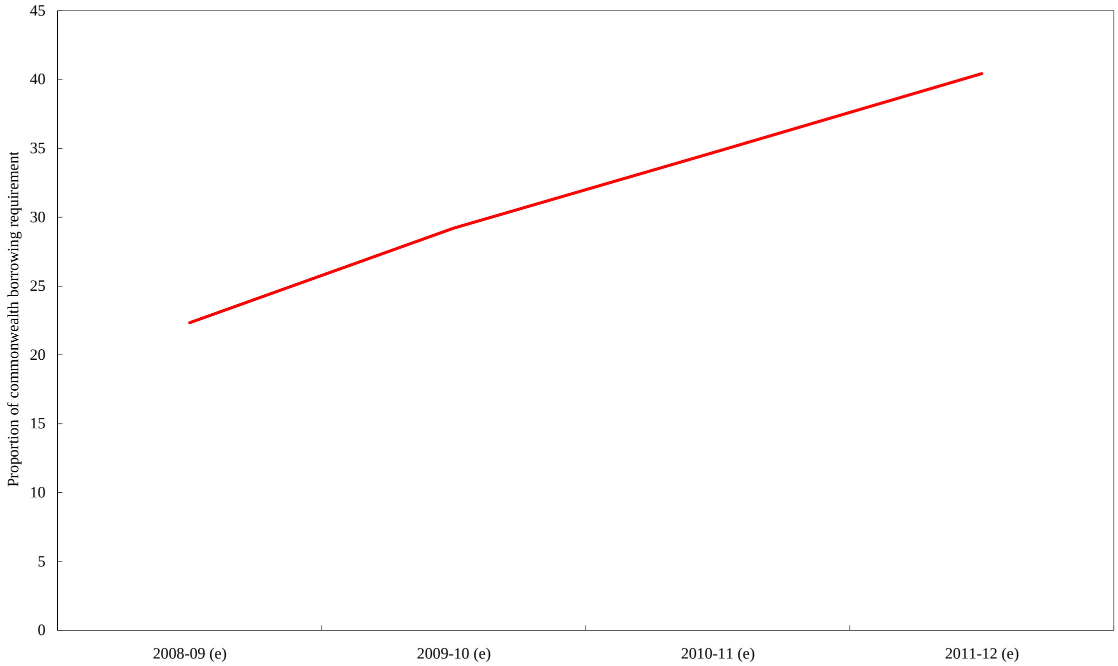
	2000-01	2007-08	2008-09 (e)	2009-10 (e)	2010-11 (e)	2011-12 (e)
GGS	2,587	-23,294	-13,359	-4,862	455	6,184
NFPS	25,677	29,903	54,774	78,042	94,263	108,683

GGS denotes the general government sector, and NFPS the non-financial public sector.
Source: State and territory government budget papers.

The additional borrowing by the states and territories over the next few years is on top of a confirmed $200 billion in borrowings to be undertaken by the commonwealth.[3] On the basis of currently available estimates, state borrowings will represent 22 per cent of commonwealth borrowings in 2008-09 and rise to 40 per cent by 2011-12 (Figure 2). In per capita terms, state borrowings are expected to increase from $2,077 in 2008-09 to $3,588 by 2011-12.

[3] It has been revealed that the commonwealth is considering exceeding its self-imposed $200 billion limit to at least $300 billion. David Uren, 2009, 'Deficit spike may lift rates as Government considers $300bn debt blowout', The Australian, 24 April.

Figure 2: State general government sector borrowing as a percentage of commonwealth government borrowing, 2008-09 and 2011-12



Source: State and territory government budget papers; IPA calculations.

Why does this matter?

Prior to the advent of Keynesianism, it was largely agreed by economists that prudent financial management by a government essentially mirrored that of an individual, family or firm. Norms of prudence were regarded as the key virtue in government budgeting, and budgets should be in balance, if not in surplus. When capital expenditures were financed by debt, sinking funds for amortisation were to be established and maintained.[4]

The pre-Keynesian norms for sound public finance were exemplified in writings by the late nineteenth/early twentieth century economist C. F. (Charles Francis) Bastable. In his 1903 book, *Public Finance*, Bastable suggested that 'under normal conditions, there ought to be a balance between these two sides [expenditure and revenue] of financial activity. Outlay should not exceed income, … tax revenue ought to be kept up to the amount required to defray expenses.'[5] To be sure, Bastable also considered that a modest surplus was also appropriate to account for extenuating circumstances affecting revenue or expenses.

Changes in the stance of fiscal policy at the state level have arguably been counterproductive not only in terms of its adherence to time-tested rules of appropriate fiscal conduct, but to the Australian economy as a whole. As the state budget papers indicate, state and territory governments rapidly reduced their surpluses during the height of the recent economic boom.

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[4] James M. Buchanan and Richard E. Wagner, 1977, *Democracy in Deficit: The Political Legacy of Lord Keynes*, Liberty Fund Edition, Chapter 2.
[5] C. F. Bastable, 1903, *Public Finance*, Liberty Fund Edition, p. 611.

As was argued in final report of the 2008 Senate Select Committee Inquiry into State Government Financial Management, these actions drove inflationary pressures throughout the economy.[6] For example, the substantial growth in the number of state public sector employees, and increases in their salaries, contributed to shortages in the availability of skilled, professional labour. After a period of insufficient infrastructure investment – including a reluctance to pursue private-public partnerships (PPPs) on a greater scale – a sudden and rapid increase in capital spending by governments contributed to rising materials, construction and labour costs.

Now, with a profile of slowing economic growth nationally, the underlying states' structural budget deficits have been exposed. There is a risk that states will seek to plug their fiscal gaps through increases in their narrow, inefficient taxes. Over the past six months the following tax increases have been announced:

- New South Wales: a new two per cent marginal tax rate on high-value land holdings, increases in nominal duty rates, rising parking levies and coal royalty rates, additional revenue due to a change in land holder duty, and deferred abolition of nuisance duties
- Queensland: a new 0.5 per cent land tax surcharge, increasing motor vehicle registration fees, increasing gaming machine tax rates, and deferral of transfer duty on core business assets
- South Australia: deferral of nuisance duties on non-quoted marketable securities and non-real property transfers.

In Victoria the government announced an infrastructure contribution charge for developers in growth areas, while an attempt to broaden the stamp duty base was quashed in March by the state parliament. That these, and other, increases in revenue have been announced in the teeth of a national recession will only tend to prolong Australia's economic downturn, to the detriment of positive employment and investment outcomes.

State governments are also turning to public sector debt to further increase expenditure. The creation of a debt bubble by states and territories is highly problematic on a number of fronts:

- Knowing that the cost of debt is paid for by future taxpayers encourages politicians to indulge in excessive spending.
- State governments have a historical tendency of supporting unproductive projects. Capital spending in the general government and trading enterprise sectors alike are invariably driven by a host of non-commercial objectives. Current and future generations bear the economic consequences of inefficient infrastructure, while future generations bear the costs of repaying the debt.
- The interest costs on state semi-government bonds must be paid ultimately by taxpayers, effectively displacing tax reductions or services expenditure in other areas.
- Public debt raised today must be serviced and retired sometime into the future, meaning that a future tax liability is to be imposed upon individuals who had not consented to the raising of debt.
- During a period of pervasive credit constraints in international financial markets, public debt financing by the states is likely to put upward pressure on interest rates in the long term and threaten private capital accumulation nationally.

[6] Parliament of Australia, The Senate, 2008, Select Committee on State Government Financial Management, *Report*, September.

- Taxpayers become increasingly exposed to fluctuating capital market conditions and other risks that could increase borrowing costs. In the Australian context, it has been well established that the Rudd federal government's guarantee on wholesale debt securities issued by banks impaired the capacity of state governments to attract purchasers of their bonds especially during late 2008-early 2009.

The erosion of sustainable state budget settings acts as a significant drag on Australia's economic prospects. Despite the prevailing view expressed by politicians and government officials that the state budgetary crisis is a consequence of the cyclical downturn in revenues, the analysis presented in this paper reveals that the weak fiscal disciplines exercised by the states have contributed to their own structural budget problems. In other words, the present budgetary difficulties facing states are the product of their own past decisions.

The state governments must put their fiscal houses back in order. Such efforts will yield substantial community benefits at any time of the economic cycle. This paper proposes three reforms to slim down big-spending state governments, resting on reductions in inefficient taxes, developing more focused expenditure priorities, and stronger fiscal rules.

Section Two

State government revenues

Over the course of this decade the general government sectors of the states and territories have enjoyed an unprecedented growth in their revenues. Indeed, the states' revenue growth from 2000-01 to 2007-08 was far in excess of what governments had originally estimated – in other words, delivering a major revenue windfall.[7]

State own taxation revenue

The major taxes levied by the states include those imposed on employers' payrolls, land and properties, and taxes on gambling, insurance products and motor vehicle transactions and usage.[8]

From 2000-01 to 2007-08, actual taxation revenue increased by an average annual rate of 7.4 per cent. Tax increases were largest in Queensland (12.2 per cent per year), Western Australia (12.1 per cent) and the Northern Territory (8.6 per cent).

By comparison, as noted in state budget papers, jurisdictions had originally forecast their tax revenues to grow on an annual basis by 3.2 per cent. The overall result was that the states and territories enjoyed a substantial tax revenue windfall of $27.3 billion over the period (Figure 3).

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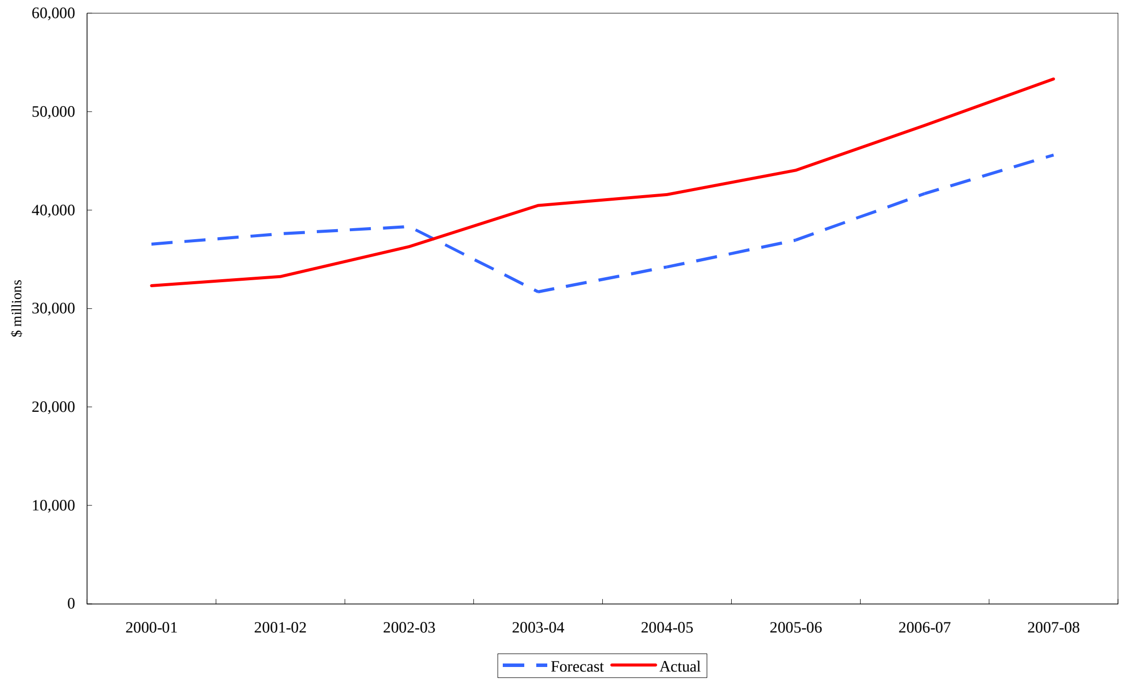
[7] The methodology used to estimate revenue and expenditure windfalls in this paper is based on an unweighted comparison of the earliest available forecast of general government sector revenue (expenditure) applicable to a given year against the actual revenue (expenditure) figure published in state budget papers.

[8] According to a 2007 study by the Business Council of Australia, the states and territories raise 33 taxes on business alone. See Business Council of Australia, 2007, *Tax Nation: Business Taxes and the Federal-State Divide*, http://www.bca.com.au/Content/101017.aspx.

Figure 3: Actual versus forecast state own taxation revenue



Including fees and fines for various years.
Source: State and territory government budget papers.

As a consequence of the introduction of the GST, which entailed the abolition of a number of nuisance state taxes, the actual amount of state tax revenue collections were initially below those levels forecast prior to the tax reform. However, from 2003-04 actual tax collections began to exceed the budget forecasts with the tax windfall trend continuing through to 2007-08.

One of the major drivers of the states' tax windfall has been the ballooning amount of taxes collected as a result of the recent (but now receding) property boom across Australia (Box 1). Taxes on payrolls and insurance also made significant contributions to the excess taxation revenues received by the states for much of this decade thus far.

During its 2000-01 to 2007-08 resource boom, Queensland received the largest state tax windfall of $11.6 billion. This was followed by Victoria ($6.0 billion), Western Australia ($5.8 billion), NSW ($1.3 billion) and South Australia ($1.2 billion).

Box 1: The operation of state property taxes

The states and territories impose a range of taxes and charges on the ownership and sale of residential and commercial property.

Land tax is generally levied on commercial, industrial and some non-owner-occupied residential land. Transfer (or conveyancing) duty is levied on the value of property purchased. Other levies, such as for metropolitan improvement programs of funding fire and other emergency services, are imposed on property owners.

Property taxes contribute about nine per cent of total Australian taxation revenue compared with an OECD average of about six per cent. The majority of Australia's property tax revenues are collected by the states.

From June 2002 to June 2008, property prices in Australia increased at a substantial rate. For residential property alone, the prices of new (project) and established homes rose by 34 per cent and 65 per cent respectively. The spike in property prices was the result of a variety of factors, including rising real incomes, land supply restrictions and government subsidies to encourage home ownership.

These price trends had a significant effect on state government property tax collections. In 2000-01, the states and territories collected about $9 billion from various property taxes – or about 27 per cent of total state own tax revenue. By 2007-08, state property tax revenues rose to about $22 billion, representing about 41 per cent of state tax revenues. This trend occurred despite the abolition of a range of nuisance property-based taxes, such as mortgage and lease duties in most states, as a consequence of the 2000 national tax reform initiative.

A range of deleterious economic impacts have been associated with the states' property tax regime. Transaction-based stamp duties tend to deter labour mobility, and distort housing choices for people at different stages in their life cycle.

The land transfer duty system adds significantly to the cost of purchasing a home, particularly for young aspirant homeowners and existing homeowners looking to buy more compact housing in retirement age, and therefore creates an inefficient use of housing stock.

Despite land taxes being lauded in some circles as the 'ideal tax', in practice they can distort production and locational decisions. Further, land taxes regularly subject taxpayers to surprising year-on-year changes in liabilities driven by a bureaucratic land valuation system.

In general, property taxes have repeatedly been identified by economists as amongst the most inefficient state government taxes.

Source: ABS, House Price Indexes: Eight Capital Cities, cat. no. 6416.0; Sinclair Davidson, 2009, 'Textbook example is not grounded in earthy reality', The Age, 13 March; OECD, 2007, *Revenue Statistics 1965 to 2006*; State and territory government budget papers.

It is widely accepted that the states and territories levy some of the most inefficient taxes in the Australian federation. A 2001 State Business Tax Review commissioned by the Victorian government found that 'stamp duties do not rate highly on efficiency grounds' and that the efficiency of land and payroll taxes are also severely compromised.[9] Joyeux and Abelson found that transaction taxes on housing imposed a deadweight loss on the national economy of some $375 million per annum.[10]

In 2008, Access Economics ranked the relative efficiency of state taxes and found that motor vehicle taxes on business, insurance duties and non-residential property conveyancing duties were amongst the most inefficient of taxes collected in Australia.[11] An assessment of NSW taxes by the Independent Pricing and Regulatory Tribunal (IPART) found that state taxes rated poorly in efficiency terms compared to commonwealth taxation.[12] The more intensive use of these inefficient tax bases to, say, reduce the gap between budget expenditures and revenues in the next few years will tend to impede Australia's growth performance during the next recovery cycle.

Commonwealth payments

One of the most significant changes in state finances since World War II was the introduction of the GST national tax reform package in 2000. As part of the reform, the states would receive the proceeds of GST revenue (less administrative costs of tax collection) in exchange for the abolition of a number of efficiency-impeding state taxes.[13]

One of the key rationales for introducing the GST reform was to equip state and territory governments with sufficient revenues to provide services for which states are responsible. As it has turned out, the GST has more than lived up to its initial promise with governments underestimating its revenue-generating capacity (Box 2).

Under the reform arrangements, it was agreed that no state would be made financially worse off from the GST. Each state is entitled to receive a Guaranteed Minimum Amount (GMA) from the commonwealth, calculated as the amount states would have received under the former financial assistance grants and state tax regimes. The difference between the GMA and GST revenue provision for each state would be met by commonwealth Budget Balancing Assistance (BBA) funding.

It was originally expected that the states would not become net beneficiaries of the GST reform package until 2006-07. However, the actual strong growth in GST revenues has meant that the states have enjoyed GST receipts in excess of their GMA entitlements (and hence no need for BBA to fill the budgetary gap) since 2003-04 (Table 2). Since 2000-01, the states and territories have enjoyed a GST windfall close to $10 billion over and above the GMA compensation threshold.

[9] Victorian Government, 2001, *Review of State Business Taxes Full Report*, http://www.dtf.vic.gov.au/CA25713E0002EF43/WebObj/FullReport/$File/FullReport.pdf.

[10] Roselyn Joyeux and Peter Abelson, 2007, 'Price and Efficiency Effects of Taxes and Subsidies for Australian Housing', *Economic Papers* 26 (2): 147-169.

[11] Access Economics, 2008, *Analysis of State Tax Reform*, Report for Financial Industry Council of Australia, http://www.ifsa.com.au/Media%20Releases/AE-FICA%20Final%20April.pdf.

[12] IPART, 2008, *Review of State Taxation*, http://www.ipart.nsw.gov.au/files/Final%20Report%20-%20Review%20of%20State%20Taxation%20-%20Michael%20Seery%20-%2017%20October%202008%20-%20PDF%20Website%20Document%20Version.PDF.

[13] Some states, in defiance of the original IGA agreement, have chosen to retain a range of taxes originally agreed to be abolished. For example, over the past six months NSW, Queensland and South Australia announced the retention of nuisance taxes earmarked for abolition under the IGA, to be abolished at a later (unscheduled) date.

Table 2: GST revenue provision in excess of Guaranteed Minimum Amount, states and territories, 2000-01 to 2007-08, $ millions

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	Actual total	GMA	GST windfall
2000-01	7,258	5,099	4,658	2,375	2,279	988	473	1,226	24,355	27,138	0
2001-02	8,132	5,593	5,019	2,518	2,477	1,060	544	1,290	26,632	30,709	0
2002-03	9,080	6,365	5,888	2,910	2,859	1,247	616	1,515	30,479	31,380	0
2003-04	9,667	6,961	6,553	3,158	3,146	1,394	658	1,681	33,219	32,172	1,047
2004-05	9,884	7,346	7,329	3,624	3,293	1,435	680	1,730	35,323	33,354	1,969
2005-06	10,362	7,833	7,689	3,804	3,442	1,496	723	1,834	37,182	35,654	1,528
2006-07	10,938	8,588	8,092	3,968	3,605	1,568	778	2,015	39,552	37,440	2,112
2007-08	11,916	9,429	8,549	3,984	3,914	1,665	846	2,207	42,330	39,054	3,276

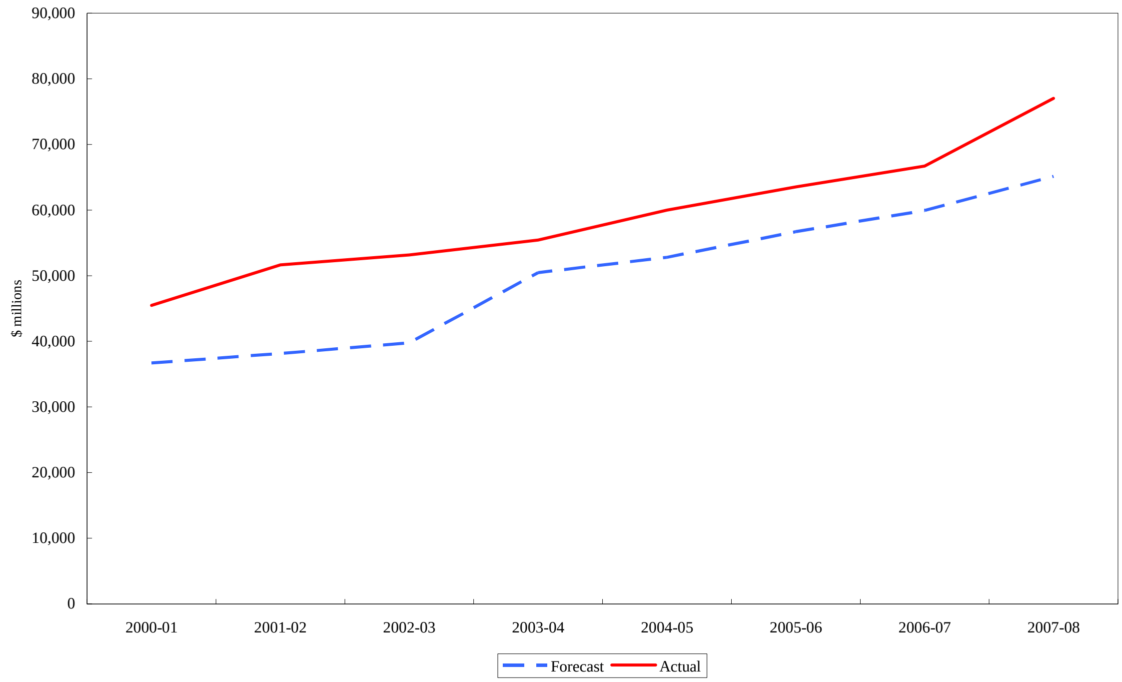
Source: Commonwealth government budget papers.

In addition to the GST and other untied assistance payments, states and territories also receive tied funding to deliver policy objectives specified by the commonwealth in areas including education, health, social security, housing and transport.[14] As part of the national tax reform agreement, the commonwealth gave an undertaking to states to maintain the aggregate level of specific purpose payments.

Putting all forms of commonwealth assistance together, the states have received a revenue windfall of $73.3 billion over and above initial projections (Figure 4).

[14] While the states are not free to spend these tied funds for purposes as they see fit, tied specific purpose payments are recorded in state budgets as a revenue source and the expenditure of these funds are recorded on the expenses side of states' budget operating statements.

Figure 4: Actual versus forecast commonwealth payments to states, 2000-01 to 2007-08



Including current and capital grants, and subsidies for various years.
Source: State and territory government budget papers.

From 2000-01 to 2007-08, Queensland was the greatest beneficiary of the commonwealth payments windfall, receiving grants in the order of $17.9 billion over and above the amount originally forecast. Victoria ($16.7 billion), NSW ($14.7 billion), Western Australia ($10.9 billion) and South Australia ($6.8 billion) also received significant windfalls in commonwealth untied and tied payments.

Ironically, the smaller states – that, in part, benefit from an implied redistribution of GST revenue due to public service cost and revenue 'disabilities' – tended to have the smallest actual increase in commonwealth payments over the period, as well as the lowest windfalls in revenue from this source.

The flow of grants from the commonwealth to the money hungry states is not without its financial or economic consequences. For example, general revenue assistance could distort state tax policies by lowering a jurisdiction's perceived marginal cost of funds.[15] Grants could also distort public service provision as states act strategically in an attempt to optimise their grant shares.[16] The expectation of bailout funds from the commonwealth alleviates incentives to undertake systemic reform to grow their own economies.

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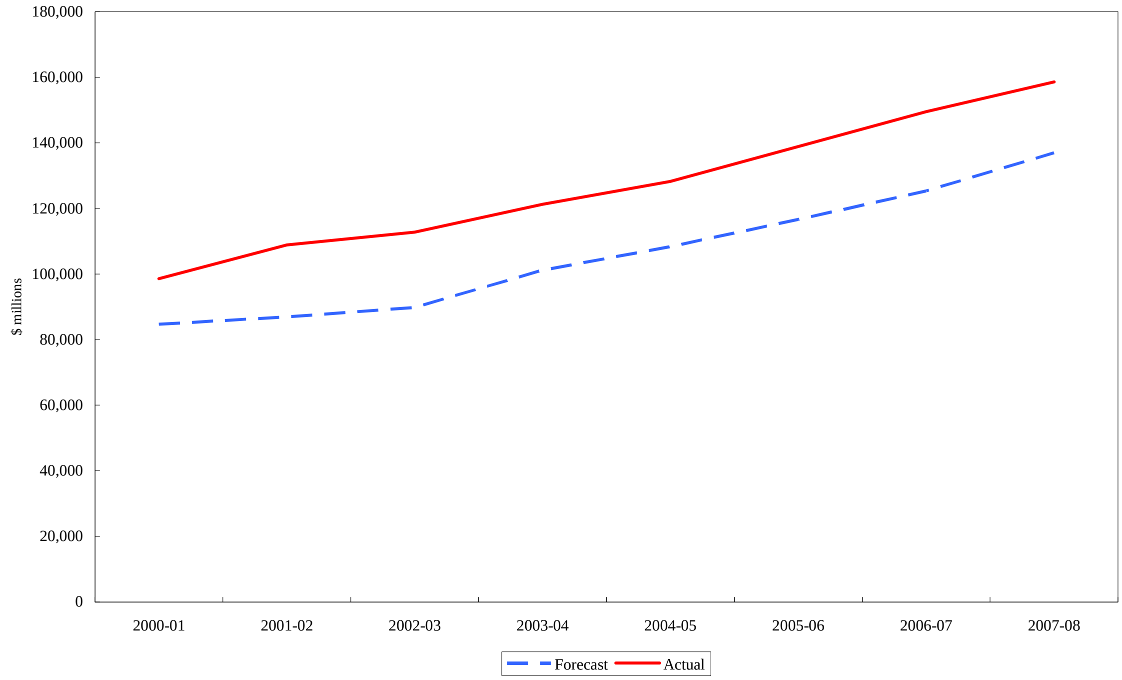
[15] Peter Swan and Gerald T. Garvey, 1995, 'The equity and efficiency implications of fiscal equalization', Swan Consultants Pty Ltd; Bev Dahlby and Neil Warren, 2003, 'The fiscal incentive effects of the Australian equalisation system', *Economic Record* 79 (247): 435-446; Bev Dahlby, 2008, *The Marginal Cost of Public Funds: Theory and Applications*, MIT Press, Cambridge.

[16] Jeff Petchey, 2008, 'A theoretical analysis of equalisation and spatial location efficiency', Curtin University, School of Economics and Finance, Working Paper No. 08.02.

Total state revenue

On the basis of total revenues received, it is clear that states and territories have enjoyed a funding windfall in excess of that originally budgeted (Figure 5). From 2000-01 to 2007-08, the states have received an 'own revenue + grants' windfall in excess of $167 billion.

Figure 5: Actual versus forecast state total revenue, 2000-01 to 2007-08



Source: State and territory government budget papers.

State own sources of revenue have shown remarkable buoyancy during a period of strong economic growth. During the period under analysis, state taxes and non-tax revenues increased by $66 billion in excess of original forecasts.

New South Wales had the largest windfall with $40.5 billion in general government revenue from commonwealth and own sources in excess of forecast amounts from 2000-01 to 2007-08 (Table 3). Following was Victoria ($40.2 billion) and then Queensland ($34.4 billion), Western Australia ($25.9 billion) and South Australia ($13.2 billion).

Table 3: Actual versus forecast total revenue, states and territories, 2000-01 to 2007-08, $ millions

	Forecast	Actual	Windfall
New South Wales	276,351	316,822	40,471
Victoria	192,807	233,045	40,238
Queensland	169,367	203,775	34,408
Western Australia	87,600	113,503	25,903
South Australia	67,947	81,184	13,237
Tasmania	21,007	26,319	5,312
Australian Capital Territory	16,516	20,447	3,931
Northern Territory	18,284	21,797	3,513
Total	849,879	1,016,891	167,012

Source: State and territory government budget papers.

It is notable that the two largest states – NSW and Victoria – had the greatest windfall despite the greater capacity of Western Australia and Queensland to secure gains from royalty revenues levied on commodities. The so-called 'two speed economy' effect did not prevent NSW and Victoria from experiencing enormous revenue windfalls, which in turn helps explain the relatively lower rate of economic growth in those two states.

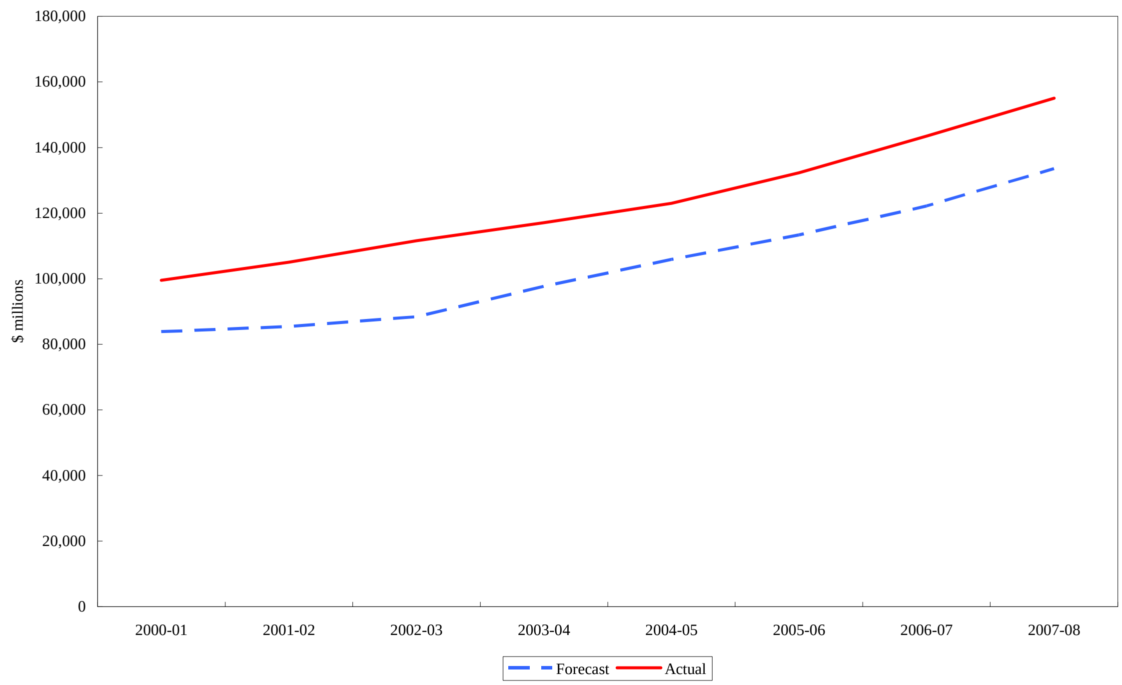
Section Three

State government expenditures

The economic consequences of poorly targeted and excessive spending by the states have been identified over a long period of time. For example, the substantial growth in the number of state public sector employees, and increases in their salaries, contributed to shortages in the availability of skilled, professional labour which, in turn, drove inflationary pressures throughout the broader economy.

From 2000-01 to 2007-08, the states and territories had initially forecast their cumulative spending to total $830.3 billion. However, actual cumulative spending over the period was in the order of $987 billion. This represented additional expenditure over initial forecasts to the tune of $156.8 billion, or a 19 per cent gap over the period (Figure 6).

Figure 6: Actual versus forecast state total expenditure, 2000-01 to 2007-08



Source: State and territory government budget papers.

The actual rate of spending in Queensland was the highest of all states, with expenditure increasing by an average of 8.4 per cent per year. The Northern Territory (7.5 per cent per annum), Victoria (7.2 per cent), WA (7.1 per cent) and the ACT (6.8 per cent) also recorded significant increases in spending on average each year.

Comparing actual expenditure with initial budgeted forecasts, NSW spent over their forecast to the tune of $47.0 billion from 2000-01 to 2007-08 (Table 4). Victoria ($38.9 billion), Queensland ($27.5 billion), Western Australia ($17.9 billion) and South Australia ($12.9 billion) rounded out the biggest spenders of the federation.

Table 4: Actual versus forecast total expenditure, states and territories, 2000-01 to 2007-08, $ millions

	Forecast	Actual	Windfall
New South Wales	264,928	311,939	47,011
Victoria	188,944	227,842	38,898
Queensland	168,153	195,646	27,493
Western Australia	86,010	103,868	17,858
South Australia	67,506	80,370	12,864
Tasmania	20,509	25,152	4,643
Australian Capital Territory	16,091	20,473	4,382
Northern Territory	18,120	21,779	3,659
Total	830,261	987,069	156,808

Source: State and territory government budget papers.

Growth in public sector employees and government wages

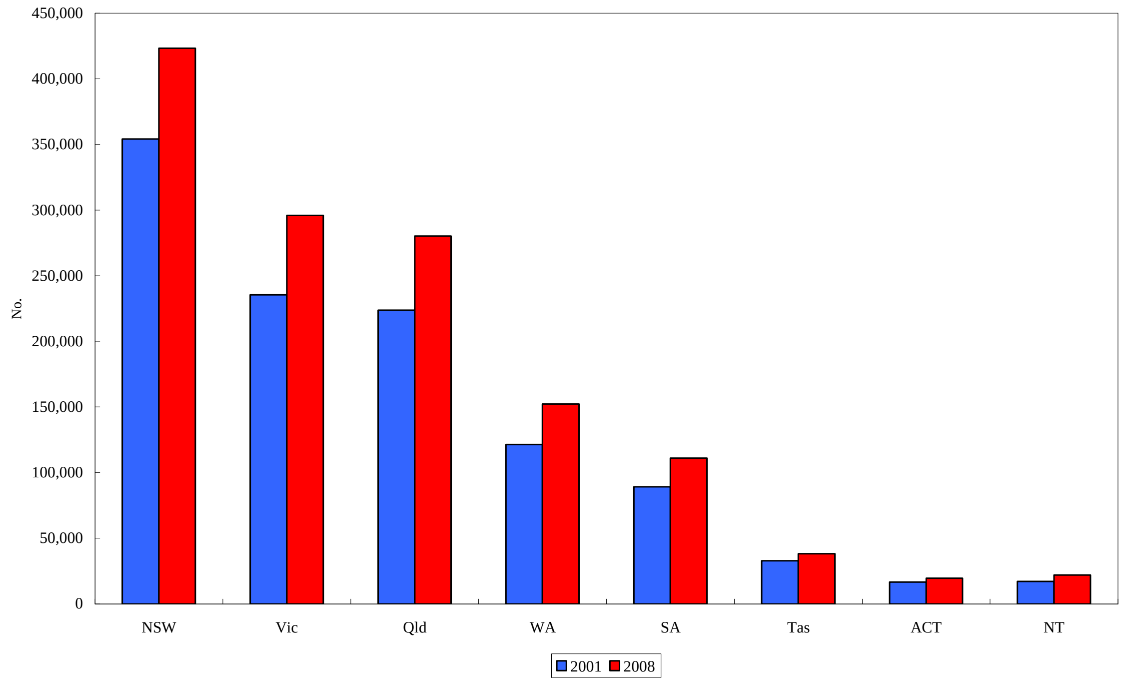
One of the striking features of the states' expenditure has been the extent to which this has been reflected in a significant increase in the number of public sector employees and their remuneration packages.

While the states themselves do not present information on the number of their employees in a consistent manner,[17] the ABS publishes data on the total number of public sector employees by state and level of government. This information not only incorporates numbers of employees within the general government sector, but other components of state governments including government trading enterprises (GTEs) and universities.

As shown in Figure 7, the number of state public sector employees has grown from about 1.1 million in 2001 to about 1.3 million in 2008. While NSW has had the biggest growth in absolute terms, strong increases in employee numbers over the period were recorded in the commodity boom jurisdictions of the Northern Territory (28.7 per cent increase), WA (25.5 per cent) and Queensland (25.2 per cent). The non-commodity state of Victoria increased the number of its public sector employees by 25.7 per cent, a particularly significant result for a jurisdiction where its government trading enterprise (GTE) sector is relatively smaller in its scope.

[17] Some jurisdictions publish annual reports containing information on the number of general government sector employees. No state provides information on the numbers of public sector employees in their budget papers.

Figure 7: Number of state public sector employees, 2001 to 2008



Data for 2001 presented as at May of that year, and as at June for 2008.
Source: ABS, Wage and Salary Earners, Public Sector, Australia, cat. no. 6248.0.55.001; ABS, Employment and Earnings, Public Sector, Australia, cat. no. 6248.0.55.002.

As this decade has worn on, the states have boosted the number of public servants. While there is some variation between the states, the rate of growth in the number of public sector employees grew from 2.6 per cent in 2002 to 4.8 per cent in 2008.

The ABS also provides details of state public sector employee numbers by industry classification (Table 5). Employees in government administration, education, health and community services (accounting for about 80 per cent of all state government workers) would constitute the majority of general government sector employees hired by states and territories.

The number of education and health workers increased by 15 per cent respectively from 2001 to 2007. As a proportion of total state public sector employees, however, the number of people in these industry classifications fell by 1.2 percentage points.

There has been a significant increase in the number of people working in government administration. In 2007, 160,900 people worked in administration compared to 98,600 in 2001 – an increase of 63 per cent over the period. State government administration personnel grew from nine per cent of the total number of public sector employees to 12.6 per cent.

Table 5: Number of state public sector employees, selected industry classifications, 2001 to 2007

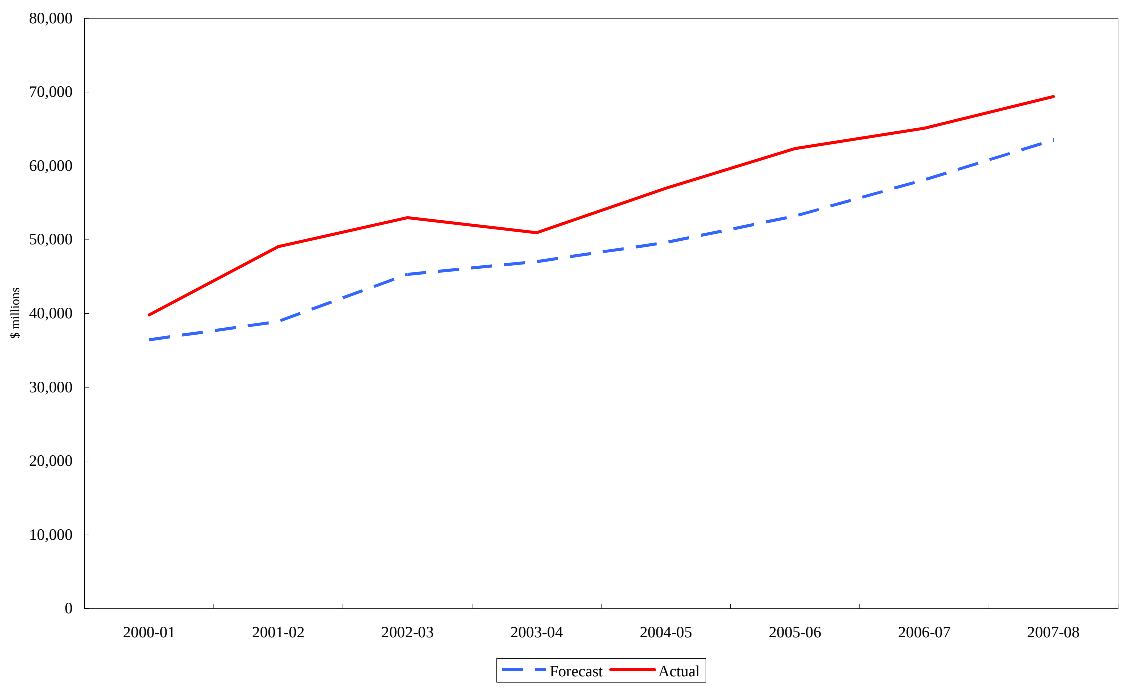
	Government administration	Education	Health and community services
2001	98,600	442,300	318,700
2002	117,600	450,000	317,500
2003	123,800	455,200	323,800
2004	129,300	483,100	337,700
2005	132,600	494,000	349,400
2006	148,300	503,100	349,400
2007	160,900	513,500	365,200

Source: ABS, Wage and Salary Earners, Public Sector, Australia, cat. no. 6248.0.55.001.

Since 2000-01 employee entitlement expenses increased by an average of 8.3 per cent per annum, well in excess of inflation over the period.

Compared to initial forecasts as outlined in budget documents, the states and territories expended an additional $54.6 billion on general government sector employee wages and salaries, and superannuation expenses (Figure 8). This additional spending above forecast on government employees represents about 33 per cent of the total windfall received by states and territories from 2000-01 to 2007-08.

Figure 8: Actual versus forecast state general government employee expenses, 2000-01 to 2007-08



Source: State and territory government budget papers.

This was almost twice the windfall states and territories received from their own taxes, and are illustrative of the states' failure to contain their own public sector wage costs in key areas of service delivery such as education (Box 2).

Box 2: State government pay deals with teacher unions

The teacher unions have also looked upon state governments as booty to be expropriated. After a fourteen-month campaign of pickets and stop-work periods, the Victorian government in mid-2008 caved in by providing an average 17.8 per cent pay increase to teachers applicable over four years.

This decision, motivated by a desire to make Victoria's government school teachers the 'best paid' in the country, has sparked a zero-sum game bidding war by teacher unions in other states. In one of its first decisions in office, the new Western Australian government granted an immediate six per cent pay increase for teachers and school administrators. Premier Colin Barnett stated that 'the increase would make Western Australian teachers the highest paid in Australia.'

This was followed by a pay decision in NSW, where teachers received a 12 per cent pay increase over three years.

Currently, South Australian teachers are calling for wage increases of 21 per cent over three years. This is despite increasing unemployment, a budget deficit in that state, and teachers being awarded an interim pay increase of 3.75 per cent in February. In early April, the Queensland Teachers' Union cited rising interstate teacher wages as a rationale for more wages for teachers in that state.

The problems posed by government employee union wage campaigns, such as those conducted by government school teachers, are explained by Charles W. Baird:

'Governments and the multitude of government agencies that actually employ public sector workers are, within their jurisdictions, monopoly providers of goods and services to taxpayers who cannot refuse to pay for those services whether they want them or not. Taxpayers do not have competing courts, police agencies, fire departments, welfare bureaus, garbage collectors, government schools, etc. from which to select. Any monopoly that hires workers can more easily pass on inflated labor costs to its customers than can enterprises which face competitors. Moreover, in the government sector employers and employees have a common interest – viz. to seek more and more resources from taxpayers.'

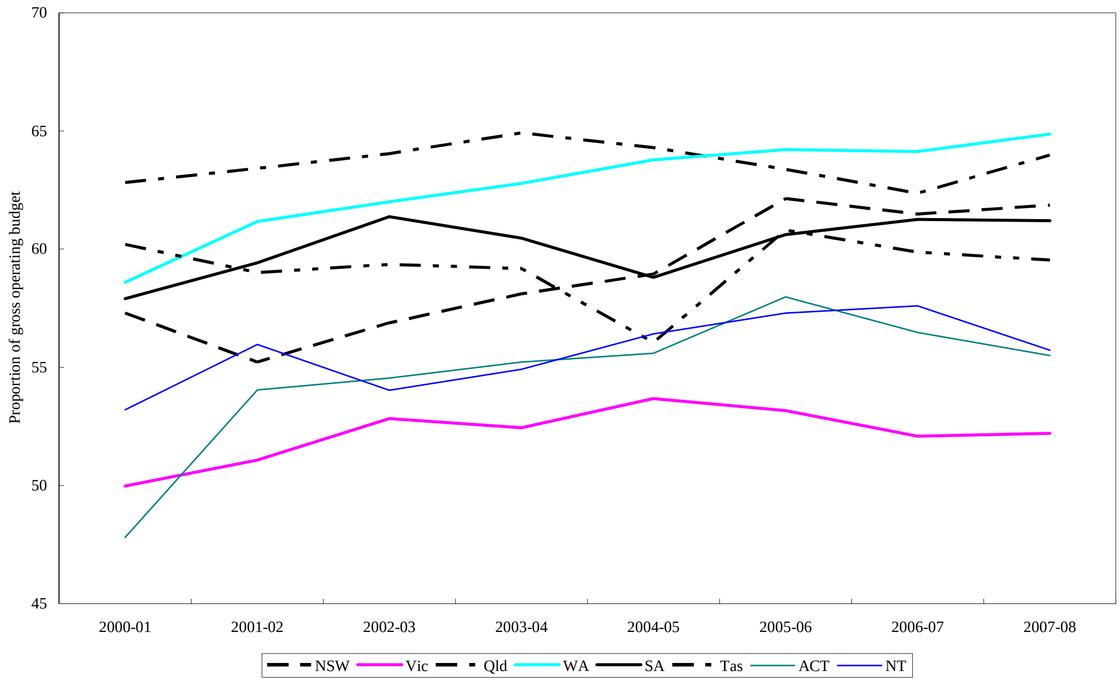
Without a stronger commitment by political representatives to use a firm hand in containing government wage costs, taxpayers will continue to be drained by the seemingly free-flowing transfer of funds to middle- and upper-class bureaucrats.

Source: Charles W. Baird, 'Public Sector Labor – Management Cooperation and Unions', http://www.cbe.csueastbay.edu/~sbesc/05juncol.pdf (accessed 18 April 2009); Julie Novak, 2009, 'Spiralling teacher wages buy teacher happiness, not much else', *IPA Review* 66 (1): 4.

Another way to look at the growth in state government employee is to consider trends in the relative importance of employee expenses to operating expenses. According to ABS government finance statistics, expenses for state general government sector employees increased from $41 billion in 2000-01 to over $69 billion in 2007-08. As a proportion of gross operating expenses, this represents an increase from 57 per cent to 60 per cent over the period.

On a state-by-state basis it is clear that employee expenses have consumed more of the state budget in every state except Tasmania (Figure 9). On the basis of currently available estimates published by states, this figure is expected to increase over the next four years.

Figure 9: State general government employee expenses as proportion of gross operating budgets, 2000-01 to 2007-08

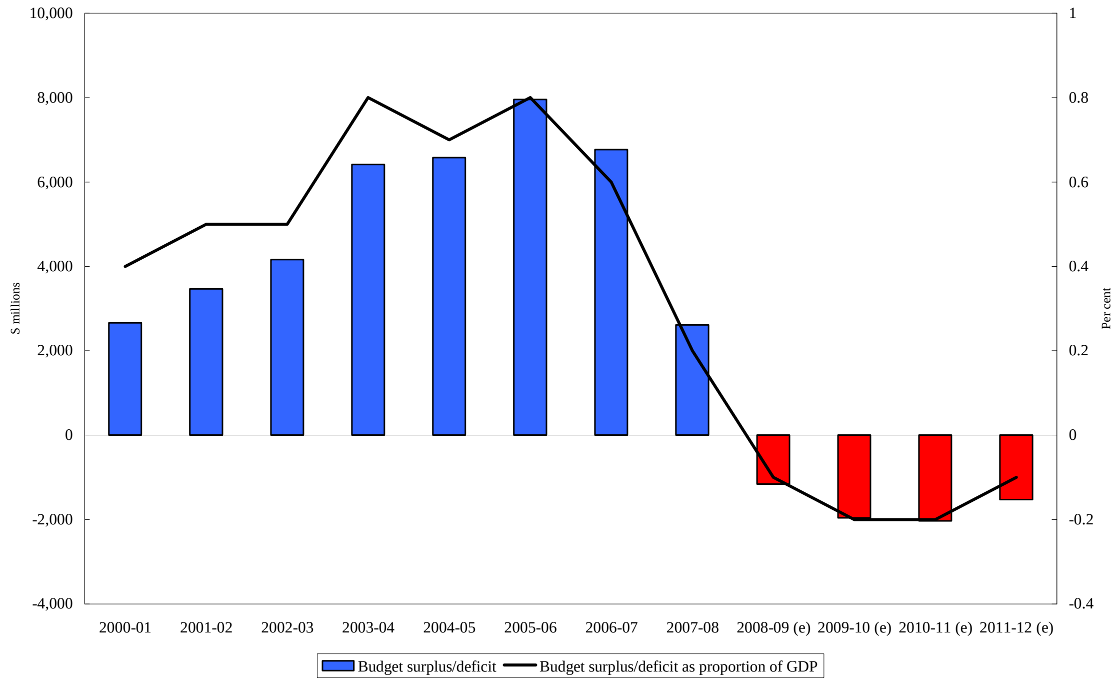


Source: ABS, Government Finance Statistics, Australia, cat. no. 5512.0.

Impact of government spending on budget outcomes

It is clear that the states and territories received a flow of revenue that was much more than they needed. This is reflected in the fact that states were able to retain an aggregate budget surplus of up to 0.8 per cent of GDP by 2005-06 (Figure 10).

Figure 10: State accrual net operating balance, 2000-01 to 2011-12



Expected net operating balance results incorporate latest forecasts outlined in state budget updates and media releases.
Source: ABS, Australian System of National Accounts, cat. no. 5204.0; Commonwealth government 2008-09 Updated Economic and Fiscal Outlook; State and territory government budget papers.

However, early warning signs that the states' financial management strategy could not be sustained have now come to a head with the spectre of deficits in the budgetary outlook. Starting with the news of a horror NSW budget deficit of $712 million expected for this financial year, a torrent of bad budget news emanated from the state capitals with announcements that four other states (Queensland, South Australia, Tasmania and ACT) had joined the deficit club. As noted above, there are expectations that budget deficits across the states could total up to $10 billion this coming financial year.

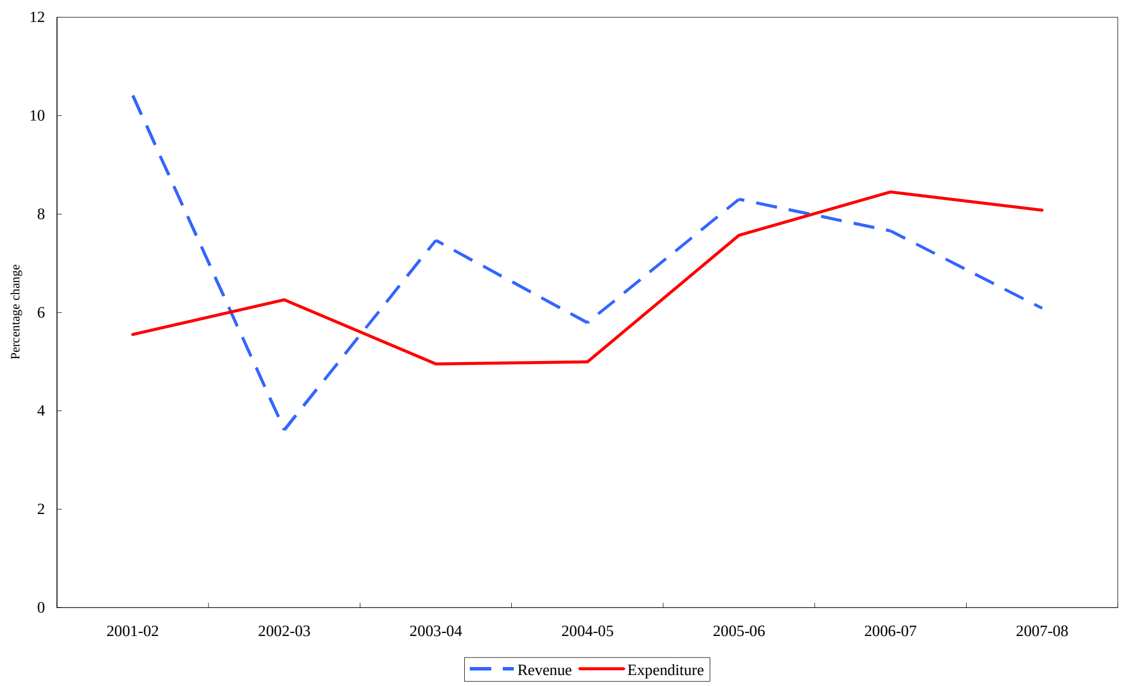
There is little question that malfunctioning global financial markets and a domestic economic slowdown over the past year have exerted pressure on state budgets. However, state treasurers have blamed the totality of their parlous budgetary situations on the economic downturn. For example, the NSW Treasurer Eric Roozendaal stated that 'the budget will come under pressure as a result of the current cyclical downturn in revenues,'[18] whilst South Australian Treasurer described the state as having taken a 'massive hit from the fallout on Wall Street.'[19]

However, this interpretation of recent events obscures the contribution of spending to the states' budgetary turmoil. Figure 11 compares the year-on-year percentage changes in revenue and expenditure, to illustrate the budgetary conduct of state governments during the recent economic good times.

[18] Parliament of New South Wales, 2009, Legislative Council Hansard, 3 March.
[19] Greg Kelton, 2008, 'Global financial crisis hits SA for $200m', Adelaide Advertiser, 27 September.

Since 2005-06, the growth in total revenues had weakened from 8.3 per cent to 6.1 per cent. By contrast, state and territory expenditure growth had risen appreciably since 2004-05 to the extent that spending growth – by that time, running at eight per cent – began to outstrip revenue from 2006-07. On the basis of latest published estimates presented by the states for this financial year, the gap between expenditure and revenue growth has grown even further.

Figure 11: State total revenue and expenditure, percentage change from previous year, 2001-02 to 2007-08



Source: State and territory government budget papers.

The contention that the budgetary problems faced by the states are driven by spending increases has been confirmed by a number of independent commentators. The South Australian Auditor General stated that South Australia 'may have developed a culture of expecting growing revenues to continue to support increasing expenses,'[20] while Victoria's Auditor General cited growth in public sector employee wages as a pressure point on that state's finances.[21] A number of submissions to the 2008 Senate Select Committee Inquiry into State Government Financial Management also pointed to the financial and economic risks posed by the states' expenditure growth.

In effect, governments continued to spend – and thereby erode their budget positions – as if the economic good times would never end. Even as revenue growth started to flatline and deteriorate, state premiers and treasurers continued to pump money out of their treasuries to favoured interest groups and seemingly without sufficient regard for the appropriateness, efficiency or effectiveness of spending.

[20] South Australia Auditor-General's Department, 2008, *Annual Report for the year ended 30 June 2008 – Part C: State Finances and Related Matters*, Government Printer, Adelaide, p. 6.
[21] Victorian Auditor-General's Office, 2008, *Auditor-General's Report on the Annual Financial Report of the State of Victoria, 2007-08*, Victorian Government Printer, Melbourne.

The problem with such a lack of fiscal discipline is that governments find it more difficult to responsibly manage their fiscal affairs. As explained by Nobel Prize winning economist James M. Buchanan:

‘Beneficiary groups, recipients of direct transfers or of governmentally financed programs, tend to be concentrated, organized, and capable of exerting influence over elected politicians. By contrast, taxpayer groups, those who pay taxes, tend to be widely dispersed and, indeed, tend to include almost everyone due to the fact that taxes are general rather than specific. As a result of the asymmetry, it becomes easier to get political decision makers to expand budgets than to contract them.’[22]

As discussed above, the fact that some jurisdictions have announced tax increases over the past six months or so reveals a deep-seated reluctance to pursue the alternative option of correcting spending levels to accommodate slowing revenue receipts.

[22] James M. Buchanan, 1983, ‘I limiti alla fiscalità’, quoted in Antonio Martino, 1989, ‘Budget Deficits and Constitutional Constraints’, *Cato Journal* 8 (3): 695-711.

Section Four

Measures of state government performance

Over the last decade state governments have devoted significantly more taxpayer resources to a wide variety of programs. The biggest spending increase was recorded in the area of health care, rising by $17.9 billion from 2000-01 to 2007-08 (or 8.9 per cent per annum).

Education expenditure rose by $12.2 billion (5.8 per cent per annum), followed by public order and safety ($7.2 billion, or 8.8 per cent per annum), transport ($5.2 billion, or 5.8 per cent per annum) and social security and welfare ($5.0 billion, or 9.4 per cent per annum).

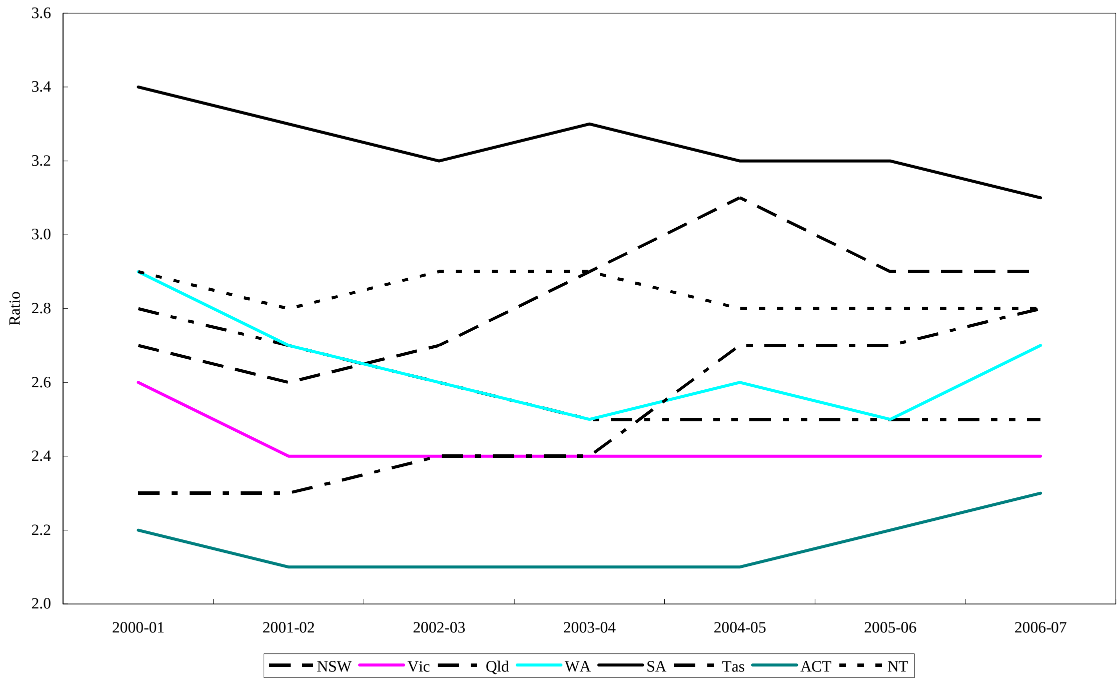
There is little question that more spending appeals to most members of the general community, but the key question is does it deliver results? It is difficult to estimate the productivity of government services, and caution should be applied when interpreting trends over time, however the available evidence suggests that the dramatic increase in state government spending has not been accompanied by equally dramatic performance improvements – at least in the two big spending areas of health and education.

Health (public hospitals)

Key performance indicators for public hospitals – also owned and managed by states and territories – suggests that taxpayers are receiving an insufficient return on the substantial amounts spent on the provision of health services.

Results for the number of licensed or available public hospital beds per 1,000 people, a basic indicator of service provision, are decidedly mixed across the states. Whilst NSW, Tasmania and the ACT have increased the number of beds for patient use, the number of available public hospital beds has declined in the face of a rising population (Figure 12). This trend has coincided with growth in the rate of public hospital separations nationally of 3.6 per cent per annum.

Figure 12: Number of licensed or available public hospital beds per 1,000 people, 2000-01 to 2007-08

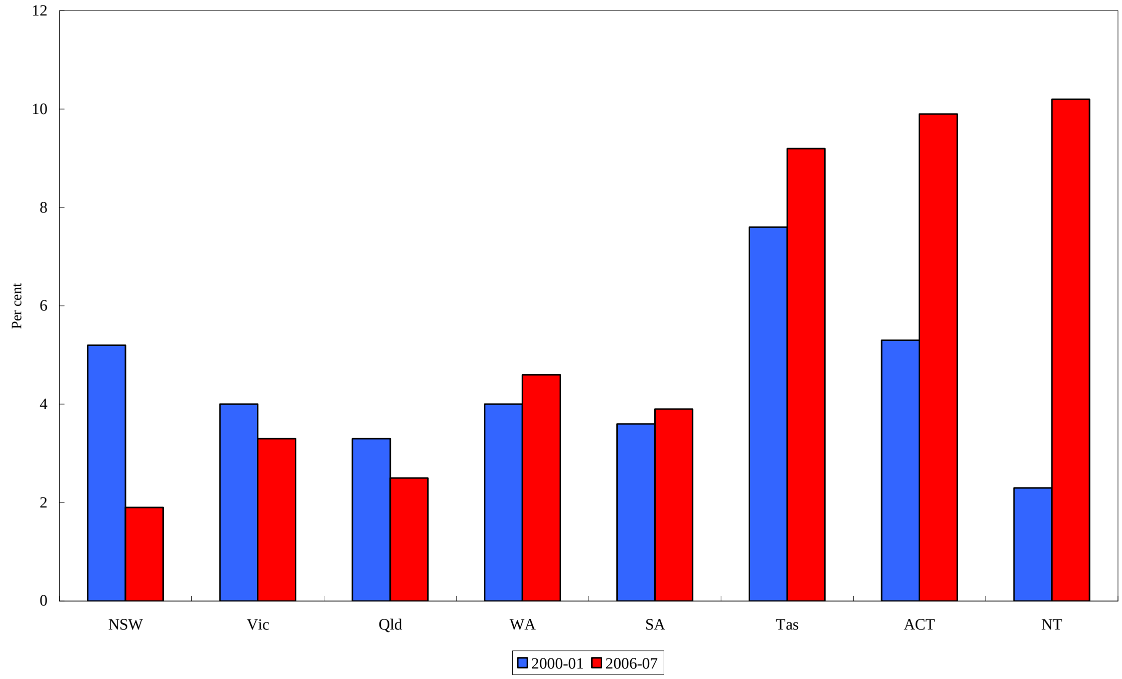


Source: Australian Institute of Health and Welfare (AIHW), *Australian Hospital Statistics*, various years.

There is clearly scope for improvement with regard to the timely treatment of patients presenting themselves at public hospital emergency departments. According to the Australian Institute of Health and Welfare, the percentage of emergency department visits seen on time has improved only in NSW, Queensland and South Australia. In most jurisdictions, there is a less than a 70 per cent chance that emergency patients will be seen in a timely manner.

The percentage of elective patients waiting for more than a year for treatment in a public hospital has increased in all jurisdictions except NSW, Victoria and Queensland (Figure 13).

Figure 13: Percentage of public hospital elective patients waiting more than 365 days for treatment, 2000-01 and 2006-07



Source: Australian Institute of Health and Welfare (AIHW), *Australian Hospital Statistics*, various years.

In April 2009, the Victorian Auditor General published a report that found significant problems in reporting hospital performance in that state, including 'data inaccuracies, data manipulation and poor quality control processes' surrounding procedures used to allocate funding to hospitals.[23] These revelations serve to reaffirm the importance of providing relevant and accurate information for the community to make robust assessments of the performance of government services that they fund.

Education (schools)

Despite a huge increase in funding by the states towards school education, which in part has contributed to a marked reduction in student-staff ratios in schools, there is little evidence to suggest a sustained improvement in educational outcomes attained by students over the past few years.

Data on the proportion of school students meeting minimum acceptable benchmarks for reading, writing and numeracy are regularly cited as an indicator of learning outcomes. There have only been noticeable improvements in Year 7 reading skills in NSW, writing skills in South Australia and numeracy skills in Victoria.[24]

[23] Victorian Auditor-General's Office, 2009, 'Auditor-General's Report: Access to Public Hospitals: Measuring Performance', Media statement, 1 April.

[24] In this context, a noticeable improvement in learning outcomes is defined as a three percentage points or more increase in the proportion of Year 7 students achieving the agreed national benchmark in reading, writing or numeracy tests in a given jurisdiction. All data presented are from 2001 to 2007, except for South Australia (2002 to 2007).

Other test results show a decline in performance by students against agreed national test benchmarks over time. Student numeracy skill test results are of a particular concern, with the proportion of Year 7 students meeting the national numeracy benchmark falling in Queensland (by 6.4 percentage points), NSW (5.8 per cent), the ACT (2.2 per cent) and Western Australia (0.3 per cent). The proportion of students meeting the numeracy benchmark remained steady in South Australia.

The results of other student testing methodologies are available on an internationally comparable basis. The Trends in International Mathematics and Science Study (TIMSS) collects Years 4 and 8 achievement data in maths and science testing.

The 2007 results from TIMSS showed mixed results for Australia. Year 4 students showed some improvement in maths achievement, however Australia's ranking for Year 4 mathematics was below countries such as Hong Kong, Singapore, Japan, Kazakhstan, Russia, England, Latvia, Netherlands, Lithuania, United States and Germany.[25] In addition, Australian Year 8 maths and Year 4 science achievement levels remained static yet there was a significant decline in science achievement for Year 8 students.

The OECD Programme for International Student Assessment (PISA) also provides internationally comparable test results for scientific, reading and mathematical literacy. The 2006 results indicate that there is still considerable scope to close the learning outcomes gap between individual states and the leading country in each test category (Table 6).

Table 6: State and territory PISA mean test scores, 2006

	Science	Mean score gap	Reading	Mean score gap	Mathematics	Mean score gap
NSW	535	28	519	37	523	26
Vic	513	50	504	52	513	36
Qld	522	41	509	47	519	30
WA	543	20	524	32	531	18
SA	532	31	514	42	520	29
Tas	507	56	496	60	502	47
ACT	549	14	535	21	539	10
NT	490	73	460	96	481	68

The 'mean score gap' is the difference between the mean test score for a given state and the mean test score for the leading country in each test category. Countries with the highest mean scores in 2006 in each category were as follows: science (Finland, 563); reading (Korea, 556) and mathematics (Taiwan, 549).
Source: Sue Thomson and Lisa De Bortoli, 2008, *Exploring scientific literacy: how Australia measures up: the PISA 2006 survey of students' scientific, reading and mathematical literacy skills*, Australian Council for Educational Research.

Given the importance of an educated and healthy population, systemic underperformance in the delivery of quality school and hospital services by the states is likely to act as a drag on national economic competitiveness and productivity. As will be discussed below, governments should actively explore increasing the role of the private sector in many areas of current state services as a way to improve outcomes.

[25] Sue Thomson, Nicole Wernert, Catherine Underwood and Marina Nicholas, 2008, *Highlights from TIMSS 2007 from Australia's perspective*, Australian Council for Educational Research; Justine Ferrari, 2008, 'Doesn't add up: Borat kids beat Aussies in maths and science', The Australian, 10 December.

Section Five

Options for reform

The above analysis has demonstrated that states and territories have been significant beneficiaries of a growth in revenue that exceeded all expectations. Governments reacted to the revenue windfalls by engaging in a 'spend quickly for today' strategy. However, to put it mildly, the jury is well and truly out when it comes to the appropriateness of the spending activities and the efficiencies attained.

Compounding the difficulties posed by the spending record throughout this decade is the fact that excessive spending during a period of economic expansion – and not a cyclical revenue downturn – has sown the seeds for the states' structural budget dysfunction as witnessed today.

The pertinent question to be asked now is what should state governments do about this? Given the likely impact that the states' approach to financial management over this decade has thrown sand at the wheels of national economic growth, answering this question becomes vital for our future economic prospects. This section proposes three broad ranging reform ideas that should be implemented by states to get their fiscal houses in order.

The power to spend is limited by the power to tax, so cut taxes

Modern approaches to public choice theory suggest that the growth in public sector expenditure is dependent on the ability of governments to acquire revenue.[26] To put more simply, government compulsorily acquires revenue in order to spend it.

Meaningful reductions in state tax burdens can make a substantial contribution to reduce spending pressures that have now contributed to poor fiscal outcomes. Tax cuts, financed by reductions in wasteful, inefficient areas of government spending, will have two additional beneficial effects:

- in the short run, it will enable businesses to retain more of their own income to invest, employ and grow their operations
- in the long run, it will reduce the efficiency costs of taxation and thus expand the productive capacity of state and national economies. This is particularly relevant in the Australian context where, as noted above, states have been found to utilise some of the most inefficient taxes across all levels of government.[27]

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[26] Geoffrey Brennan and James M. Buchanan, 1980, *The Power to Tax: Analytical Foundations of a Fiscal Constitution*, Cambridge University Press, Cambridge; Randall G. Holcombe, 2005, 'Government Growth in the Twenty-First Century', *Public Choice* 124: 95-114.

[27] A number of studies have emerged in recent years highlighting the inefficiencies of current state taxation. A 2001 State Business Tax Review commissioned by the Victorian government found that 'stamp duties do not rate highly on efficiency grounds' and that the efficiency of land and payroll taxes are also severely compromised. Joyeux and Abelson found that transaction taxes on housing imposed a deadweight loss on the national economy of some $375 million per annum. In 2008, Access Economics ranked the relative efficiency of state taxes and found that motor vehicle taxes on business, insurance duties and non-residential property conveyancing duties were amongst the most inefficient of taxes collected in Australia. An assessment of NSW taxes by the Independent Pricing and Regulatory Tribunal (IPART) found that state taxes rated poorly in efficiency terms compared to commonwealth taxation. See Victorian Government, 2001, *Review of State Business Taxes Full Report*; Roselyn Joyeux and Peter Abelson, 2007,

In late 2008 the IPA released a major study that benchmarked the liabilities of taxation imposed on business in each state.[28] Adopting a 'reference business' approach based on World Bank competitiveness studies, the IPA calculated state business tax liabilities for: payroll tax; land tax; stamp duties on the sale and purchase of land and buildings, vehicles and insurance premiums; vehicle registration fees and (for selected industries only) workers' compensation premiums.

The benefit of the IPA analysis is not only that state business tax liability can be analysed on a comparable basis, but interstate variations in liability points to those locations where excessive tax burdens exist (Table 7).

Table 7: State business tax liabilities, 2008

	Payroll tax	Land tax	Land transfer duty	Insurance duty	Vehicle duty	Vehicle registration fees	Total
NSW	160,645	18,001	34,282	5,049	2,179	2,200	222,356
Vic	136,146	7,302	47,383	6,158	2,463	2,969	202,421
Qld	136,587	20,623	31,267	4,310	1,232	3,369	197,388
WA	140,273	4,525	38,311	6,158	4,002	2,353	195,621
SA	137,421	29,099	41,243	6,773	1,817	2,714	219,067
Tas	139,716	28,033	32,032	4,926	2,463	3,010	210,179
States' average	141,798	17,930	37,420	5,562	2,359	2,769	207,839

WA taxes including Metropolitan Regional Improvement Tax. Excluding workers' compensation premiums.
Source: Institute of Public Affairs.

If jurisdictions initially look to tailored tax reductions in specific areas of excessive taxation, as part of a broader strategy to significantly reduce tax burdens across the board over time, this would unleash a 'double dividend' that not only encourages market growth but tightens the reins of unwieldy state budgets.

Smaller state governments by focusing on what's really needed

In his classic text *An Inquiry into the Nature and Causes of the Wealth of Nations*, Adam Smith explained that government should fund those limited activities 'though they may be in the highest degree advantageous to a great society, [they] are, however, of such a nature, that the profit could never repay the expense to any individual or small number of individuals.'[29]

In 2007-08, about 22 per cent of state general government spending was on the core functions of law and order, justice and administration, and interest expenses on debt and superannuation liabilities.[30]

'Price and Efficiency Effects of Taxes and Subsidies for Australian Housing', *Economic Papers* 26 (2): 147-169; Access Economics, 2008, *Analysis of State Tax Reform*, Report for Financial Industry Council of Australia; and IPART, 2008, *Review of State Taxation*.

[28] Julie Novak, Kate Herbert and Sinclair Davidson, 2008, *Business Bearing the Burden: The Size and Impact of State Government Business Taxes: The IPA State Business Tax Calculator*, IPA Occasional Paper, http://www.ipa.org.au/library/publication/1234324833_document_business_bearing_the_burden_-_report.pdf (accessed 17 April 2009).

[29] Clearly, this definition of a 'public good' is distinct from the erroneous notion – often peddled by political actors, public sector unions and other pro-spending vested interests – that a public good is one that is 'good for the public.' See Alex Robson, 2007, 'The abuse of economic terminology in public debate', *IPA Review* 59 (2): 39-40.

[30] Julie Novak, 2009, 'In a state of dysfunction', The Australian Financial Review, 14 January.

State expenditures, in other words, have been devoted to functions far beyond that cited by economists as the appropriate preserve of collective action.

In order to reduce government spending enabling budgets to get back into balance, the states need to regain their focus on what kinds of services are essential for the community – such as funding education and health services, keeping streets and communities safe, and contributing towards infrastructure development – and jettisoning those that are not – such as sport stadiums, public art galleries, 'picking winners' industry grants, international trade roadshow junkets or, as in the case of Queensland, maintaining unionised public works departments.

Even in the current era of growing state government, private sector alternatives are abundant in the remaining areas of government spending. A simple 'Yellow Pages' telephone book test shows that there exists a complex services 'ecosystem' of not-for-profit primary and secondary schools, for-profit or not-for-profit hospitals, child care centres, welfare and charitable organisations, art galleries and recreational facilities, and private infrastructure development groups.

It should be noted that individuals and families that use these private alternatives are also funding (through state own revenues or GST) standardised state government services. To prevent these and other families from paying twice for the privilege of using non-governmental services, the states and territories should embrace 'purchaser-provider' standards in service delivery. This means that governments would retain a funding role, while opening up the direct provision of services to non-governmental entities.

There are some clear candidates for reform along these lines. For example, existing government schools, including in socially disadvantaged areas, could be operated by non-profit or for-profit entities. Students could receive portable student funding entitlements from governments, adjusted for educational needs, which can be used to pay for school education.

In the area of health care, more public hospital patients could be treated in private hospitals with government funding for treatments following the patient. Current public hospitals could be operated by non-government providers, as has occurred previously in Victoria, Queensland, South Australia and Tasmania.

These and other reforms would lead to state government expenditure being more focussed on the core functions of government. This can greatly reduce the burden of taxes and other revenues upon businesses and citizens,[31] and ease the administrative complexities associated with managing a 1950s model of universal service delivery. All of these impacts would, in turn, favourably improve the likelihood of states maintaining better budget discipline into the future.

[31] Numerous surveys also illustrate that outsourcing the delivery of services to the private sector will yield significant cost-saving dividends for the community. In a summary of 71 studies, Mueller stated that 'state-owned companies were found to be significantly less efficient than privately owned firms supplying the same good or service. The provision of a good or service by a state bureaucracy or by a state-owned company generally leads to lower residual profits, and/or higher costs and lower productivity.' A survey of international studies by the Industry Commission also found that taxpayers can secure ongoing cost savings as a result of the contracting of government services. See Industry Commission, 1996, *Competitive Tendering and Contracting by Public Sector Agencies*, Report No. 48; Dennis C. Mueller, 2003, *Public Choice III*, Cambridge University Press, Cambridge.

Strengthen fiscal rules to keep government lean, but not mean

Since the last disastrous flirtation by the states with 'budget deficits as pro-growth policy' in the late 1980s, particularly by the southern states, jurisdictions have gradually adopted a variety of legislative mechanisms and policies to promote more sustainable fiscal outcomes (Table 8). These changes have been accompanied by other reforms including revisions of accounting standards adopted by government agencies and greater consistency of budget presentations to aid transparency.

It is clear from recent experience that the existing fiscal rules and policies have been ill-equipped to the task of restraining strong public sector growth, whereby excessive recurrent spending growth has led to a failure to maintain sustainable state public finances over time.

The tax-and-spend fiscal actions by state governments over much of this decade also appear to be impervious to other important constraints such as political competition and interstate and global resource mobility. Therefore, to help strengthen overall fiscal discipline exercised by the states, it will be necessary to circumscribe their ability to rapidly spend and to erode the budget bottom line.

Table 8: State fiscal responsibility legislation and policies

Jurisdiction	Legislative or policy framework
New South Wales	*Fiscal Responsibility Act 2005* specifies medium and long term fiscal liability and debt targets, and principles of budget surplus, constrained net services costs and managing public sector employee costs, intergenerational equity and maintain or increase general government net worth. Maintain net operating surplus.
Victoria	*Financial Management Act 1994* outlines principles of sound financial management, including prudent financial management risk, tax and spending to ensure taxation stability and predictability, tax system integrity, intergenerational equity, and disclosure of financial information. Short term objective of net operating surplus equivalent to one per cent of revenue, and long term maintain substantial budget operating surplus.
Queensland	Charter of Social and Fiscal Responsibility includes principles of competitive tax environment, affordable services, borrowing for capital investment only, managing financial risk and building state net worth. Maintain overall general government operating surplus.
Western Australia	Maintain general government sector operating surplus, maintain or increase public sector net worth, retain AAA credit rating, and tax competitiveness.
South Australia	Maintain at least net operating balance in general government sector, reduction in net financial liabilities to revenue ratio, effective tax regime, value for money services, fully fund superannuation liabilities, prudently manage risks, and borrowing to invest on commercial terms.
Tasmania	Maintain general government net operating surplus on average over rolling four-year period, reduction in debt and liability burdens, competitive business and tax environment, infrastructure investment, and risk management.
Australian Capital Territory	Maintain general government net operating surplus, maintain AAA credit rating, manage debt prudently, fully fund superannuation liability, maintain quality services, and tax revenue at sustainable levels.
Northern Territory	*Fiscal Integrity and Transparency Act 2001* outlines principles of sound fiscal management and public reporting of fiscal performance. Achieve general government net operating balance in medium term, appropriate infrastructure investment levels, competitive taxes, and reduce net debt plus employee liabilities.

Source: State and territory government budget papers; state legislation websites.

An effective way to keep state government conduct within appropriate fiscal bounds is to renovate the existing generic fiscal rules by combining balanced budget rules with tax-and-expenditure limitations (TELs). A balanced budget rule is a statutory or constitutional condition that a jurisdiction must achieve a balanced budget on a year-on-year basis. A TEL is a statutory or constitutional provision that limits the growth of government expenditures or revenues, generally either to a ratio of population growth plus inflation growth, income growth or economic growth, and in some instances allowing taxpayers to approve or reject spending or tax increases through a referendum process.

These stronger forms of fiscal rules are predominant in the United States. According to the US National Conference of State Legislatures, 30 American states currently operate under a TEL with 23 states having spending limits, four with tax limits and three with a combination of both. About half of the existing TELs are constitutional provisions and the other half are statutory.[32]

In practice, there is significant variation in the design features of TELs imposed by the American states. One of the more prominent TEL models in the US is the Colorado Taxpayer Bill of Rights (TABOR) – a constitutional measure introduced in 1992. Under TABOR, all tax increases must be approved by taxpayers and that existing TELs (passed in 1977 and 1991) cannot be weakened without taxpayer approval. TABOR limits growth in state expenditure and tax increases to inflation plus population growth, with any revenue collected in excess of the limit be refunded to taxpayers.[33]

A voluminous literature has emerged investigating the fiscal effects of these constraint mechanisms in the US, with many studies finding them to be effective in constraining public sector growth (Box 5).

Box 5: How effective have TELs been in containing the growth of American state governments?

A number of empirical studies have been undertaken to explore the effectiveness of TELs in the American states. In one of the first panel data studies controlling for population and income factors that influence spending, Elders (1992) found that TELs significantly reduce the growth of US state governments.

Stansel (1994) compared state spending growth rates with TELs to the national average before and after the passage of TELs. He found that state expenditure of 0.8 per cent above average before TEL implementation, and 2.9 per cent below average after passage. When comparing states with and without TELs, Stansel estimated there was a 5.3 percentage point restraint in the level of per capita state expenditure in TEL jurisdictions.

Reuben (1995) addresses the issue that earlier studies critical of the impacts of TELs may have had biased results. Using a model with instrumental variables to separate the impact of TELs from any changes in voter tastes, she found that spending declines by 1.8 per cent due to TELs.

Bails and Tieslau (2000) incorporate a range of fiscal institutions, including TELs and balanced budget requirements, in their panel study to find that real per capita state and local expenditure in TEL states is

[32] Bert Waisanen, 'State Tax and Expenditure Limits – 2008', National Conference of State Legislatures, http://www.ncsl.org/programs/fiscal/telsabout.htm (accessed 12 February 2009).
[33] Michael J. New, 2001, 'Limiting Government through Direct Democracy: The Case of State Tax and Expenditure Limitations', Cato Institute Policy Analysis no. 420.

$42 lower than in states without TELs. In states with both TELs and balanced budget rules, spending is reduced by $135 on a per capita basis.

More recent studies have refined the empirical analysis by accounting for differences in TEL design. Based on this type of analysis, New (2001) finds that TELs passed by initiative, which limit increases in revenue and spending to the sum of inflation and population, and that immediately return surplus funds to taxpayers tend to be more effective in reducing government spending.

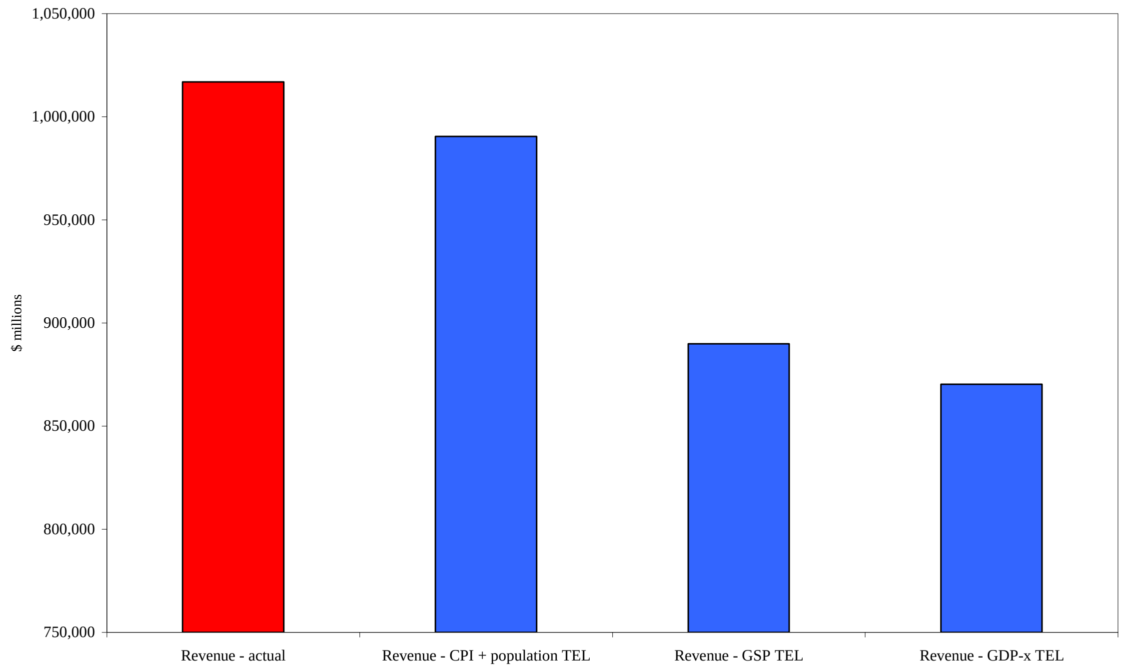
Source: Harold E. Elder, 1992, 'Exploring the tax revolt: An analysis of the effectiveness of state tax and expenditure limitation laws', *Public Finance Quarterly* 20 (1): 47-63; Dean Stansel, 1994, 'Taming Leviathan: Are Tax and Expenditure Limits the Answer?', Cato Policy Analysis no. 213; Karen Reuben, 1995, 'Tax Limitations and Government Growth: The Effect of State Tax and Expenditure Limits on State and Local Government', MIT Department of Economics Working Paper; Michael J. New, 2001, 'Limiting Government through Direct Democracy: The Case of State Tax and Expenditure Limitations', Cato Institute Policy Analysis no. 420.

What would be the indicative fiscal impact of the introduction of TEL across Australian states and territories? Figure 14 illustrates the cumulative revenues – and hence the implied savings to taxpayers – if the states adopted either a broad-based TEL regime fixing revenue growth to either one of three rules:

- inflation growth plus population growth (real per capita rule)
- GSP growth (economic growth rule), or
- GSP growth, minus a factor of x (Davidson-Novak rule).[34]

[34] The Davidson-Novak TEL refers to a rule whereby revenue to be permitted to grow at the rate of gross state product (GSP), less a factor of x nominated by governments. See Sinclair Davidson and Julie Novak, 2008, *Sustaining Growth: Reforms for Tasmanian Prosperity*, Part One, Report for Tasmanian Chamber of Commerce and Industry.

Figure 14: Cumulative revenue under alternative government sector tax and expenditure limitation rules, 2000-01 to 2007-08



For GSP and GSP-x TEL scenarios, it is assumed that when GSP (or GSP-x) growth in a state is less than zero then permissible revenue growth is set at zero. For GSP-x rule it is assumed that x is set by all states to one.
Source: State and territory government budget papers; ABS, Australian Demographic Statistics, cat no. 3101.0; ABS, Consumer Price Index, Australia, cat. no. 6401.0; author calculations.

A real per capita TEL rule would have reduced the cumulative call on taxpayers to the tune of $26.4 billion from 2000-01 to 2007-08. This is broadly equivalent to the tax windfall received by states over that period. Queenslanders would have received the largest cumulative revenue saving of $10.6 billion, followed by residents of Western Australia ($7.1 billion revenue saving), South Australia ($3.8 billion), Northern Territory ($1.7 billion) and NSW ($1.2 billion).

Alternatively, an economic growth TEL setting revenue growth to that of the overall economy would have reduced general government revenues by a cumulative $107.8 billion – equivalent to almost two-thirds of the states' revenue windfall. Residents in NSW would have received the biggest benefit from a GSP revenue growth rule TEL, with a reduction in revenue of $32.9 billion, followed by Victoria ($23.6 billion), Queensland ($23.4 billion), Western Australia ($11.0 billion) and South Australia ($9.7 billion).

A GSP-x TEL (where x is set at one) would have further limited cumulative revenues acquired by governments. Under the Davidson-Novak rule, state residents across Australia would have saved $146.6 billion from 2000-01 to 2007-08. In NSW, the cumulative revenue savings would have been in the order of $45 billion, followed by Victoria ($32.9 billion), Queensland ($31.4 billion), Western Australia ($14.6 billion) and South Australia ($12.7 billion).

It is important to note that a TEL is not necessarily a recipe for reducing the size of government, but for ensuring that adopting jurisdictions stick to a budget plan reducing the risk of taxing and spending at rates beyond what is necessary. During the recent economic boom, states increased revenue by seven per cent on average each year. This created an environment where spending increased rapidly at a similar rate in recent years.

If states adhered to a condition whereby revenues rose by a combination of CPI growth and population growth then revenue would have increased by 4.7 per cent per annum. Under GSP or GSP-x growth rules, state general government revenue would have increased by a far more manageable 3.4 per cent and 2.4 per cent per annum respectively. Revenues still rise under the TEL scenarios presented in this paper – in other words, government is kept lean but not mean, compared to the current revenue free-for-all.

As noted above, a fiscal constitution for the states should also include a requirement to balance the yearly budget. This rule would ensure that government agents are obliged to consider ways of funding their spending decisions. It would also prevent governments from hoarding excess revenues, and not returning these takings back as tax cuts to the population.

If a real per capita TEL requirement were combined with a balanced budget rule across all states, and if jurisdictions maintained their expenditure as forecast, taxpayers could have enjoyed a cumulative $186.6 billion revenue reduction. A similar revenue savings dividend could have been achieved by a combination of the Davidson-Novak TEL and balanced budget. An economic growth TEL plus balanced budget condition would have delivered total revenue savings of $167.5 billion from 2000-01 to 2007-08.

These indicative estimates suggest one thing: under a stronger fiscal rule regime, state government activity could have been kept on a fiscal diet without sacrificing the delivery of core responsibilities or diluting budget discipline.

Conclusion

It has become fashionable in recent times for economists and policymakers to instinctively train their gaze back to the 1930s for remedies to the current economic downturn. As the state governments scour through the pages of that tumultuous decade, they would do well to reflect on the following passages uttered in Melbourne in the winter months of 1930:

'Australia must be treated as a whole, and the reactions of interstate finance and of State … finance are essential to a complete view. In this matter the fortunes of the whole are the fortunes of the parts, and the failure of any of the parts will be the failure of the whole.
The characteristics of the Budget position are that … nearly all the States have had Budget deficits for at least three years. These have resulted in accumulated deficits largely unprovided for except by temporary methods of finance …
Apart from the actual Budget position there is an unfunded … [national] … floating debt of about £3,000,000, and over and above that there are internal maturing securities between now and December of … some £24,000,000 for the States …
The yield of taxation, already at a heavy level in relation to the national income, is substantially dropping, and may be expected to drop more. …
In short, Australia is off Budget equilibrium … and faced by considerable unfunded and maturing debts … in addition to which she has on her hands a very large programme of loan works for which no financial provision has been made.'[35]

These words, spoken by Sir Otto Niemeyer in his capacity as adviser to the Scullin federal government, have a familiar, yet most unwelcome, ring to them for the states and territories in the current climate.

As this paper explains, the budgetary problem befalling the states at present is an accumulation of problems built up over the course of this decade. In particular, the end of the recent national economic boom period has blown the cover off state government spending that has proven to be unsustainable.

Indeed, the spending highs have sown the seeds of the collective deterioration of the bottom lines of state budgets now being witnessed, bringing the capacity of jurisdictions to perform the basics of financial management into question. The persistence of these budget shortfalls, if left unattended, is likely to threaten the prospects of an economic recovery that Australia needs to help head off rising unemployment.

With the 2009-10 budget season about to commence in earnest, the light of scrutiny will be shone on the fiscal plans offered by states and territories with greater intensity than before. Solid evidence that incumbent governments are finally prepared to engage in reforms that pare back spending, enabling them to live within their means, should be the ultimate criterion by which their budgetary offerings should be judged.

[35] E. O. G. Shann and D. B. Copland, 1931, *The Crisis in Australian Finance 1929 to 1931: Documents on Budgetary and Economic Policy*, Angus & Robertson: Sydney, p. 19-21.