Next Generation State Budgets: Stronger Fiscal Rules for Better Budgetary Outcomes and More Prosperous States

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Contents

Executive summary

- Most state government budgets have emerged from the global financial crisis with a clean bill of health, however new pressures such as a rising Australian dollar, slowing consumer spending flowing through to GST receipts, and wage pressures from new public service pay negotiations are squeezing state budgets.
- In these circumstances there is a temptation for state governments to allow their budgets to slide into fiscal deficit or to fund expenses with the proceeds of public sector borrowing, with implications for fiscal sustainability and economic growth.
- To strengthen fiscal discipline exercised by the states, jurisdictions should actively investigate options to strengthen their existing fiscal rules to constrain the growth of revenue takings, expenditures and public indebtedness.
- This paper examines the budgetary implications of a variety of fiscal rule regimes applied at the state and local government levels. In combination with an annual balanced budget condition, three expenditure limitation rules are examined:

  (a) constraining the growth of spending to that of inflation plus population growth.

  (b) constraining the growth of spending to that of gross state product.

  (c) constraining the growth of spending to that of gross state product, minus a factor of 'x' as determined by the government.
- Based on a comparison of state/local budget trajectories under these three rules with the actual path of revenue and spending growth reveals that, in most instances, governments have acquired excessive amounts of revenue and have overspent during the course of the last decade.
- If excess revenue over spending were rebated to taxpayers, residents in each jurisdiction would have received between $146 billion and $260 billion in cumulative rebates from 2000-01 to 2008-09.
- To strengthen the enforceability of such rules, issues such as public sector debt caps, financial penalties for politicians and senior bureaucrats presiding over violations of fiscal rules, and monitoring of rule adherence by independent fiscal authorities, should be considered.
- Stronger fiscal rules offer to prospect of keeping state governments on a more effective 'fiscal diet' without necessarily sacrificing the delivery of core responsibilities or diluting budgetary discipline.

Introduction

'What is prudence in the conduct of every private family can scarce be folly in that of a great kingdom.'

(Adam Smith, [1776] 1999, An Inquiry into the Causes of the Wealth of Nations, Book IV Chapter II, p. 33, Penguin edition)

'if you want to improve politics, improve the rules, improve the structures.'

(James Buchanan, 1995, Interview with Federal Reserve Bank of Minneapolis)

The deterioration of state and territory government budgets during the later years of the past decade, particularly during the global financial crisis (GFC) of late 2008, has been largely the product of excessive spending growth over a decade.

According to information presented in recent budget papers, the states' consolidated budget surplus position will erode from a pre-GFC high of $9 billion in 2005-06 to virtually zero this financial year. Improvements in the fiscal outlook for NSW and Victoria are being counterbalanced by a significant deterioration in Queensland's budget, which is expected to post a deficit to the tune of $1.7 billion.

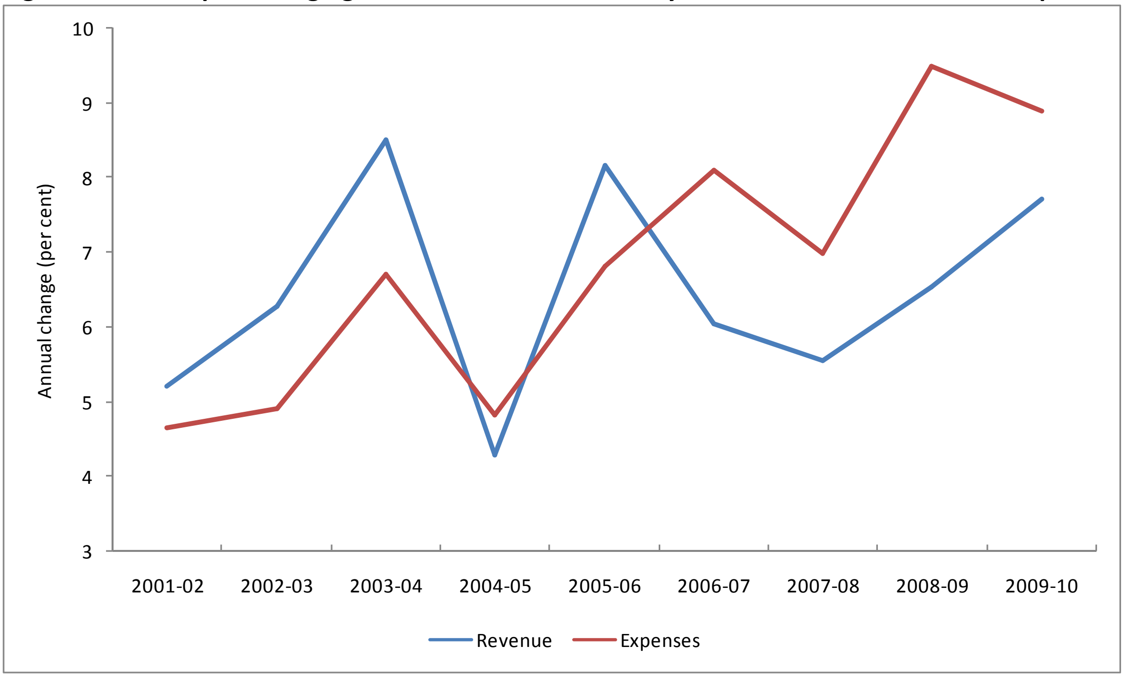
New economic and financial pressures are likely to put pressure on state governments, as they prepare to release their latest budgets from May to September this year.

A rising Australian dollar is expected to reduce state revenues, including mining royalty receipts, by up to $1.4 billion over the next eighteen months,[1] subdued consumer sentiment is being reflected in relatively weak retail sales with implications for the amount of GST revenues to be received by states, while a number of states such as Victoria are facing crucial wage negotiation rounds with public sector workers such as police and health care workers.

According to figures published in state budget papers and related statements, annual general government expenditure growth began to outpace growth in revenue collections (including commonwealth grants proceeds) around the peak of the previous commodity boom (Figure 1). When this trend occurs on a consistent basis – as it has for the states and territories – there is a heightened risk that budget deficits will follow.

[1] Peter Kerr, 2011, 'High $A squeezes state budgets', *The Australian Financial Review*, 30 March.

Figure 1: Annual percentage growth in state and territory consolidated revenues and expenses



General government sector. Figures are expressed in nominal terms.
Source: State and territory government budget papers and financial statements.

Spending growth is projected to exceed revenue growth again in this financial year of 2010-11, aggravating the precarious consolidated budget position of the states and territories.

The consequent funding shortfall has contributed to resurgence in state government net debt. It is projected that consolidated general government sector net debt will rise to $41 billion by 2014, compared with a negative net debt position last year. When accounting for the financial activities of government trading enterprises, the non-financial public sector net debt owed by all states is projected to increase to $169 billion by the end of the forward estimates.

Since the previous disastrous flirtation by the states with 'budget deficits as pro-growth policy' in the late 1980s, jurisdictions have gradually adopted legislative mechanisms and policies to promote more sustainable fiscal outcomes.[2] These changes were accompanied by other reforms including revisions to accounting standards adopted by government agencies and greater consistency of budget presentations to promote public transparency.

While most jurisdictions are expecting a strong recovery in their budget bottom lines at various periods over the next four years, it is clear that existing fiscal rules and policies have been ill-equipped to the task of restraining strong state public sector growth. The tax-and-spend fiscal

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[2] As suggested in a 2005 OECD research paper on fiscal rules, '[f]or sub-central governments who have enjoyed borrowing autonomy and have adopted fiscal rules to restrain their own policymakers, the experience of fiscal crises has provided an important motivation for adopting such rules. … recessions in the early 1990s strained the existing fiscal frameworks in a few sub-central governments in … Australia, spurring governments to adopt rules requiring balanced budgets and medium-term debt reduction or elimination.' Douglas Sutherland, Robert Price and Isabelle Joumard, 2005, 'Sub-Central Government Fiscal Rules', *OECD Economic Studies* 41: 141-181, p. 143.

actions by state governments over much of this decade appear to have been impervious to other institutional constraints such as political competition and resource mobility.[3]

State governments retain significant influence over economic growth and productivity, through their taxing, spending and fiscal management frameworks. If these policy levers are mismanaged, or cost pressures on budgets become magnified, the condition of state government finances could hamper the ability of the national economy to continue to recover over the medium term.

Synchronised budget deficits and growing public debt at the state level may threaten private sector investment activities, while the prospect of higher state taxes to plug budget gaps could impair future economic growth and market productivity outcomes.

To help strengthen fiscal discipline exercised by the states as a way to underpin our national prosperity, it will argued in this paper that a new generation of fiscal rules are required to promote fiscal sustainability.

After a more detailed discussion of state budget trends over the past decade, a discussion of the rationale for fiscal rules will be canvassed. This will be followed by an analysis of subnational fiscal rules adopted in Anglosphere countries.

The budgetary implications of alternative stylised fiscal rules for each state and territory will then be estimated. This analysis will illustrate that the profiles of revenue raising and expenditure, and the resultant budget bottom line, are sensitive to the type of fiscal rule adopted.

Design features and complementary institutions to strengthen adherence to fiscal rules, such as tying the remuneration of political representatives and senior bureaucrats to sound state budget outcomes, will also be discussed.

[3] Julie Novak, 2009, *State finances at the crossroads: The states' budget problem, and what to do about it*, Institute of Public Affairs Occasional Paper, May.

Australian state government budget trends

For most of this century to date, the Australian economy has grown strongly. According to national accounts data supplied by the Australian Bureau of Statistics (ABS), gross domestic product (GDP) rose from $970 billion in 2000-01 to $1.3 trillion in 2090-10 - an increase of about 32 per cent over the period. The amount of economic output per head of population has also increased (15 per cent from 2000-01 to 2009-10), amounting to a considerable improvement in living standards for Australians.

While the twelve months since September 2008 had been punctuated by a discernable reduction in economic activity (proxied by GDP per capita in real terms),[4] two decades of microeconomic reform - such as labour market flexibilities, tariff reductions and a floating exchange rate - has helped to ensure that Australia weathered the economic challenges more effectively than most other OECD economies.

Given the direct effects of economic change upon governmental finances, a key question to be asked is how have the states and territories managed in this regard during a decade of almost ceaseless prosperity? Analysis of trends pertaining to various financial aggregates will provide key insights in answering this question.

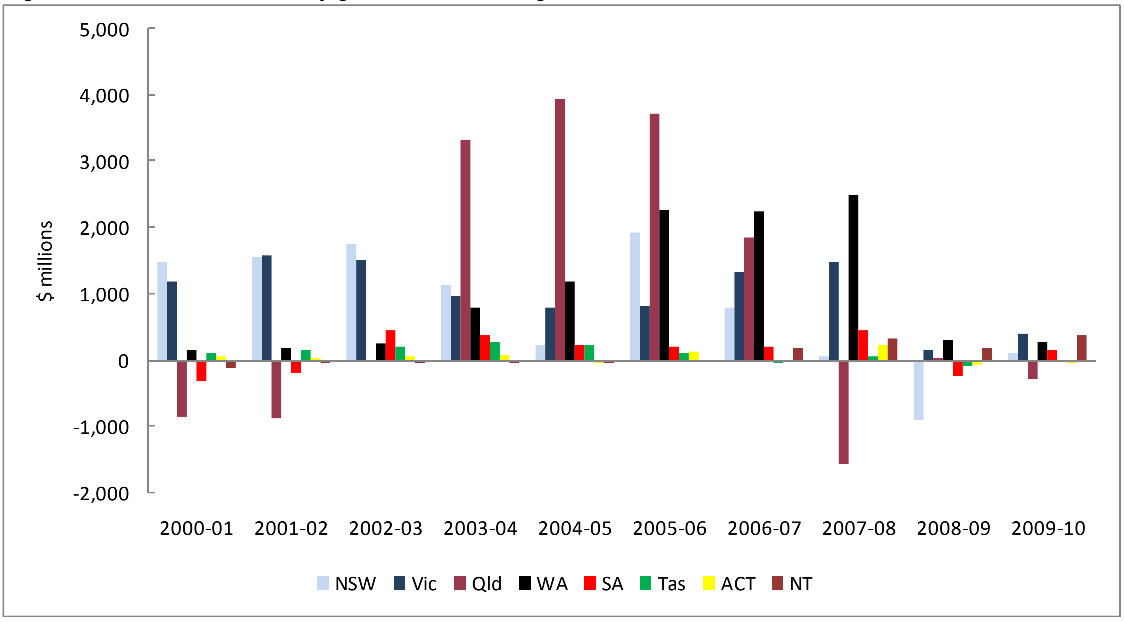
Budget balance

The budget balance expresses the difference between revenue and expenditure, and reveals how much of the revenue raised by government remains within a financial year after its spending activities are fulfilled. It provides an indication of the sustainability of the existing level of government services.[5]

Most jurisdictions recorded accrual budget surpluses, albeit of varying levels, for much of the last ten years (Figure 2).

[4] Steve Kates, 2009, 'Read the data: it was a recession', *The Australian*, 14 September; Steven Kates, 2010, 'What Neo-Keynesianism has Wrought', *Quadrant* LIV (3): 59-63.
[5] Commonwealth of Australia, 2010, *Australia's Federal Relations 2009-10*, Budget Paper No. 3, p. 138.

Figure 2: State and territory government budget balance



General government sector. Figures are expressed in nominal terms.
Source: State and territory government budget papers and financial statements.

At the start of the previous decade, the two largest states of NSW ($1.5 billion) and Victoria ($1.2 billion) enjoyed the strongest budget surplus figures. Western Australia and Tasmania recorded modest surpluses in excess of $100 million. By contrast, Queensland, South Australia and the Northern Territory incurred budget deficits.

The relative fiscal positions of the states shifted dramatically as the decade wore on. As commodity prices strengthened on the back of rising global demand, and a population influx boosted revenues from property taxes, Queensland and WA displaced the two largest states as those jurisdictions possessing the strongest budget surpluses.

In 2004-05 the Queensland government recorded a peak $3.9 billion surplus, whereas WA recorded its surplus peak ($2.5 billion) in 2007-08.

However by the peak of the previous economic cycle, in 2007-08, a number of jurisdictions were facing budgetary problems.

The economically underperforming NSW found that its previous position of fiscal strength deteriorated substantially as the decade wore on, as had Tasmania. Queensland, which had long prided itself on its ability to maintain strict fiscal discipline, experienced an adverse turnaround in its budgetary fortunes. In 2007-08 it recorded a budget deficit of $1.6 billion (compared to a surplus of $1.9 billion from the previous year).

A year later, NSW, South Australia, Tasmania and the ACT also incurred budget deficits, with NSW ($897 million) recording the worst deficit result in Australia. This trend revealed a growing incapacity of many jurisdictions to fund existing services given the inflow of revenues.

In 2009-10 trends in state budget bottom lines had been mixed. Some states (NSW, South Australia and Tasmania) recorded budget surpluses after a period of deficit during the previous year, while Victoria marginally strengthened its surplus position. On the other hand, Queensland and the ACT both recorded budget deficits last financial year.

Revenues

As described by generations of modern economists from Joseph Schumpeter to public choice theorists, the extent to which governments expend funds is contingent on their ability to compulsorily acquire revenue.[6]

State governments acquire part of their revenues to fund their general government operations from a host of taxes, including those imposed on employers' payrolls, land and properties, gambling activities, insurance products and motor vehicle transactions and usage.[7]

State budget papers and financial statements provide a record of trends in revenue collections. In 2000-01, the states and territories collected $32.7 billion in taxation revenue (or 32.3 per cent of total general government sector revenue). By 2009-10 the tax take increased to $54.2 billion (or 29.3 per cent of general government revenue).

The average annual increase in state own tax revenue was in the order of six per cent over the period. The growth in state taxation has been strongest in Queensland (9.3 per cent per annum), Western Australia (9.1 per cent), the Northern Territory (7.1 per cent), South Australia (5.8 per cent) and Tasmania and Victoria (5.4 per cent).

It is notable that the growth in state tax imposts were generally well in excess of inflation and population growth.

General grants (including receipts of GST revenue) and specific grants revenue from the commonwealth government have assumed relatively greater importance in the overall state and territory revenue mix.

From 2000-01 to 2009-10 commonwealth payments to the states have increased from $47.4 billion (or 46.8 per cent of total general government sector revenue) to $96 billion (51.9 per cent), effectively assisting in bailing out the states during the GFC period.

There is significant interstate variability regarding the share of commonwealth grants in total general government sector revenues. This is influenced by factors such as GST revenue distribution affected by the Commonwealth Grants Commission fiscal equalisation process, and political decisions by the commonwealth regarding the distribution of non-general purpose payments such as National Partnership Payments.

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[6] Joseph Alois Schumpeter, 1918, 'The Crisis of the Tax State', in Joseph A. Schumpeter, 1991, *The Economics and Sociology of Capitalism*, edited by Richard Swedberg, Princeton University Press, Princeton; Geoffrey Brennan and James M. Buchanan, 1980, *The Power to Tax: Analytical Foundations of a Fiscal Constitution*, Cambridge University Press, Cambridge.

[7] A business operating in each jurisdiction could potentially be subject to up to 117 taxing points. NSW had the highest number of state business taxes (22), followed by Victoria and South Australia (both 21) and Queensland (20). PricewaterhouseCoopers, 2009, What is your company's Total Tax Contribution? 2008 survey results, http://www.pwc.com.au/tax/assets/Tax-Contribution-08.pdf (accessed 29 March 2010).

Grant funds channeled through Canberra account for 81.5 per cent of the Northern Territory's general government funds in 2009-10, while they account for 46.2 per cent of total revenues for WA. That commonwealth grants now account for more than half of states' consolidated general government revenues (including 50.5 per cent of revenue in Victoria, Australia's second largest state) should be a source of great concern from the perspective of maintaining decentralised financial and public policy autonomy within the Australian Federation.

Looking at state consolidated general government revenue from all sources, jurisdictions had clearly amassed significant revenues during recent years in excess of both population growth and inflation.

In 2000-01 states and territories had acquired $5,328 in revenue per person in real terms, climbing to $6,225 in 2008-09 - an increase of $986 (or 18.8 per cent) per man, woman and child in Australia over the period.

At various times during the past three years a number of state treasurers warned of the impact of the GFC on their revenue bases, however fears of a precipitous revenue decline had been overstated (Box 1).

Box 1: The global financial crisis: The states' revenue bust that wasn't

In recent years state and territory treasurers have sought to lay the blame the totality of their weakening budget positions on an economic downturn.

In early 2009, the NSW Treasurer Eric Roozendaal stated that 'the budget will come under pressure as a result of the current cyclical downturn in revenues.' A few months earlier South Australian Treasurer Kevin Foley described his state as having taken a 'massive hit from the fallout on Wall Street.' The Victorian and Queensland Treasurers also referred to a reduction in revenue consequent to the GFC.

Are these claims well founded? Have state government revenues fallen during, and since, the global financial crisis of late 2008?

While consolidated taxation receipts fell in 2008-09 compared to the previous year these accounted for less than a third of consolidated state general government sector revenue. A more appropriate indicator is the total revenue acquired by the general government sectors of states and territories.

According to state budget papers and annual financial reports, consolidated total revenue was $170.8 billion in 2008-09. This compared with revenues totalling $159.6 billion the previous year. This amounted to an increase of over $11 billion or seven per cent.

The latest state budget documents show that consolidated total revenue is likely to increase again this financial year to $185 billion.

An even more representative figure of the changes in state revenue positions can be established by removing commonwealth specific purpose payments (including National Partnership

Payments) to, and through, the states, which are presently counted by jurisdictions as part of their revenue base.

In 2008-09, untied consolidated total revenues were $128.7 billion – or $1.1 billion (one per cent) larger than in the previous year. It is expected that untied revenues will increase to $135 billion during 2009-10.

This analysis reveals that the states did not suffer revenue shortfalls as a result of the global financial crisis and associated economic downturn, contrary to the protestations of certain state government political representatives. The budget shortfalls observed in a number of jurisdictions are instead largely attributable to a continuous pattern of excessive recurrent spending.

Source: Commonwealth government budget papers; Greg Kelton, 2008, 'Global financial crisis hits SA for $200m', Adelaide Advertiser, 27 September; Parliament of New South Wales, 2009, Legislative Council Hansard, 3 March; state and territory government budget papers and financial statements.

Expenditures

The states and territories have used the record amounts of revenue at their disposal to expend in equally record measure.

In 2009-10 it was estimated that about $188 billion was expended by jurisdictions on the provision of government services, up from about $100 billion in 2000-01.[8] About 53 per cent of the additional expenditure on services was directed toward education and health functions.

There were also significant increases in expenditure between 2000-01 and 2009-10 on public order and safety, housing and community amenities, and transport and communications.

A proportion of this increased spending was allocated towards the various recurrent operating expenses of governments. For example, an extra $34 billion (or 39 per cent of the additional $88 billion expenditure on services) was spent by the states and territories on the payment of employee expenses of bureaucrats and other public sector workers.

From 2000-01 to 2009-10, Western Australia recorded the highest annual average growth in employee expenses (8.8 per cent), followed by Queensland (8.4 per cent), the ACT (7.9 per cent), Victoria (7.3 per cent) and South Australia (6.4 per cent).

Recent studies suggest that the dramatic increases in state government spending have not been accompanied by commensurate improvements in areas such as health, education, policing and infrastructure services delivery.[9]

As discussed above, the growth in state and territory expenditures outstripped revenue collections as the economy grew strongly. This pattern has proved to be unsustainable as the excessive spending contributed to the emergence of budget deficits at the state level.

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[8] Based on ABS Government Finance Statistics (cat. no. 5512.0) and state and territory budget papers.
[9] Henry Ergas, 2007, *State of the States*, Menzies Research Centre; Julie Novak, 2009, *State finances at the crossroads: The states' budget problem, and what to do about it*, Institute of Public Affairs; Julie Novak, 2009, *A growing risk: The impacts and consequences of rising state government employment*, Institute of Public Affairs.

Indeed, concerns about the lack of effective cost controls exercised by the states and territories have been aired by experts in public sector financial management over a considerable period of time (Box 2).

Box 2: Assessments of state and territory government financial management

A host of reports have been released over the past few years assessing trends in state government financial management.

A 2006 report of the Audit of Expenditure and Assets (Vertigan-Stokes report), commissioned by the NSW government, found that the state's expenses were growing more strongly than revenues:

'The key challenge facing the NSW Government's finances has been the difference between the growth rates of budget expenses and revenue. In the last five years, expenses have risen by around 6 per cent per year while revenues have risen by about 5 per cent per year. This difference in growth rates of 1 percentage point per annum, applied to an annual budget of $40 billion, means expenses have increased by $400 million more than revenues each year.'

The Vertigan-Stokes report found that 'since 2002-03 Budget surpluses have declined.' They stated further that 'addressing the weakening trend in the overall Budget position will involve slowing growth in total expenses.'

The South Australian government established a Sustainable Budget Commission, to provide recommendations to assist the government move the state's finances back towards a sustainable position. The Commission's second report, released in August 2010, found that 'overall decision-making discipline could be improved, keeping budget program spending within revenue limits. Restoring net operating surpluses as soon as possible should be the Government's top priority.' The Commission identified $1.6 billion in operating savings measures by 2013-14.

The Senate established a Select Committee to investigate aspects of state government financial management. The Committee report, released in late 2008, painted a picture of rapidly growing public sector expenses fuelled by recurrent cost increases. In particular, '[i]ncreases in public sector wage expenditure appear, in some jurisdictions, to be excessive. The proportion of budget expenditure going to fund the public sector is significant, meaning that even modest wage increases can have dramatic effects on the budget bottom line.'

A 2008 report for the Tasmanian Chamber of Commerce and Industry (TCCI), prepared by economists Sinclair Davidson and Julie Novak, found that the state government was consistently living beyond its means. Specifically, Tasmanian own-tax revenue barely covered spending on public goods whereas '[a]ll the merit goods provided to Tasmanians are paid for by somebody else.'

Other independent commentators have noted that state budgetary problems have been aggravated by spending increases. The NSW Audit Office 2009 report on the total state sector accounts revealed a series of 'significant and consistent overruns of budgeted expenditure' that contributed to the overall budget deficit result for the state.

In 2008, the South Australian Auditor General stated that South Australia 'may have developed a culture of expecting growing revenues to continue to support increasing expenses,' while Victoria's Auditor General previously cited growth in public sector employee wages as a pressure point on that state's financial position.

Source: Sinclair Davidson and Julie Novak, 2008, *Sustaining Growth: Reforms for Tasmanian Prosperity*; New South Wales Audit of Expenditure and Assets, 2006, *New South Wales Audit of Expenditure and Assets Report*; New South Wales Audit Office, 2009, *Auditor-General's Report to Parliament: Total State Sector Accounts*, Volume Four, Senate Select Committee on State Government Financial Management, 2008, *Report*; South Australia Auditor-General's Department, 2008, *Annual Report for the year ended 30 June 2008 – Part C: State Finances and Related Matters*; South Australia Sustainable Budget Commission, 2010, *Budget Improvement Measures: Restoring Sustainable State Finances*; Victorian Auditor-General's Office, 2008, *Auditor-General's Report on the Annual Financial Report of the State of Victoria, 2007-08*.

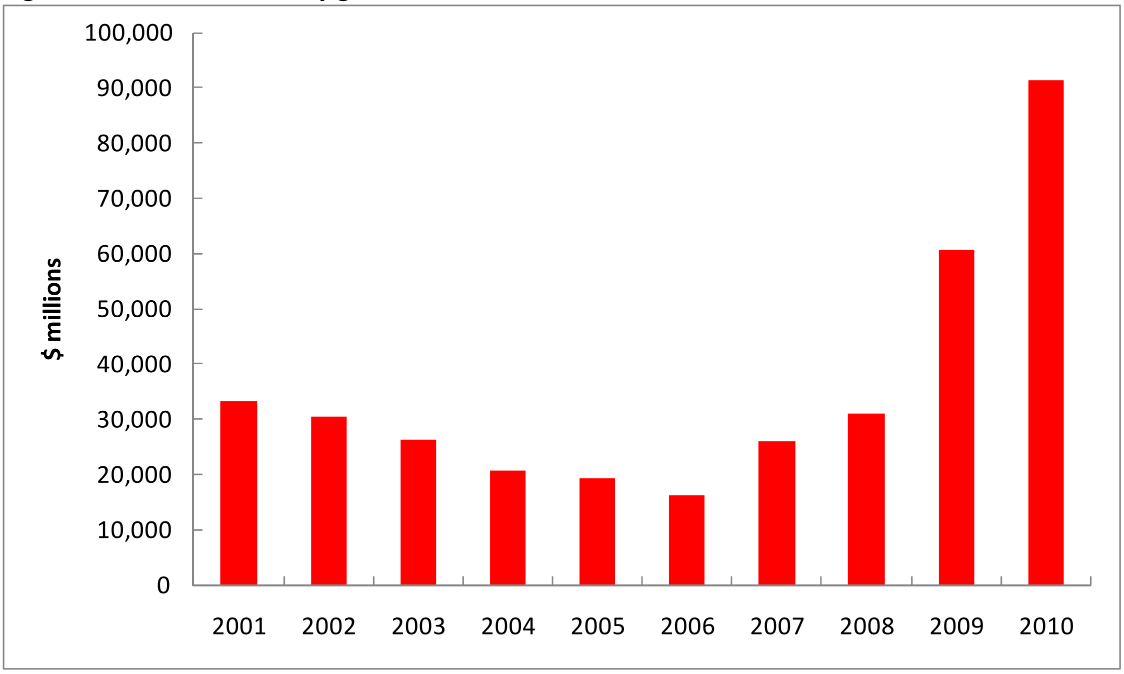
Government debt

In addition to compulsorily acquiring revenue, governments also fund their activities through borrowing funds from domestic and international capital markets.

Net debt is a common measure of the fiscal sustainability of a government, and is defined as the sum of deposits held, advances received and borrowings (financial liabilities) less the sum of cash and deposits, advanced paid and investments, loans and placements (financial assets). As borrowings today must be serviced sometime into the future, relatively high levels of net debt represent a significant call on future revenue flows limiting a government's flexibility to deliver tax cuts or expend on core services.

Given that core government departments as well as public trading enterprises engage in borrowing activities, it is appropriate to consider trends in net debt levels for the consolidated state and territory non-financial public sector (Figure 3).

Figure 3: State and territory government consolidated net debt



Non-financial public sector. Figures are expressed in nominal terms.
Source: State and territory government budget papers and financial statements.

From June 2001 to June 2006 there was a gradual reduction in the amount of total state net debt, consistent with improving budget surpluses across most jurisdictions.

Since that period there had been an almost six-fold increase in net debt compared to 2006 levels, as governments engaged in additional capital expenditure in a (lagged) response to observed production constraints throughout the economy.

Looking ahead: Revenues rebound, but spending still unsustainable and debt far too high

The 2010-11 state budgets provide some clues as to the expected movement by governments of key fiscal aggregates over the forward estimates period.[10]

Consistent with signs of a strong rebound in economic activity, jurisdictions are anticipating a considerable increase in their revenues.

Budget papers released this year show that states and territories had forecast tax receipts for this financial year totalling $57.7 billion. By comparison the state budgets published last year revealed forecasts of total taxes for 2010-11 of $55.9 billion – a forecast increase of three per cent over twelve months. Jurisdictions also revised upwards their tax revenue forecasts for 2011-12 and 2012-13.

[10] The results presented in this section do not incorporate the revisions provided in mid-year budget review documents released by states in the second half of 2010.

Alongside the growth of state revenues the spending of governments at the state/territory level will continue to grow, albeit at a slower rate over the forward estimates giving rise to an increase in consolidated budget surpluses.

The latest budget papers released by jurisdictions this year project general government expenditures by all states and territories to rise to $195 billion in this financial year to $214 billion by 2013-14.

While the projected rate of expenditure growth will slow to three per cent per annum by 2013-14, governments still expect to expend an additional $19 billion of taxpayer funds over the latest available forward estimates.

Notably, employee expenses (excluding superannuation expenses) are projected to rise by $11.1 billion representing about 60 per cent of total projected expenditure growth over the period. This significant increase incorporates the financial flow-through effect of collective agreements struck between governments and certain public sector employees (e.g., nurses, police and teachers) in recent years.

The trend presented in the budget papers is for net debt of both the state general government and non-financial public sectors to still increase strongly over the forward estimates.

According to the latest financial data provided by the states, consolidated general government sector net debt is projected to increase from $5 billion in 2010 to $41 billion in net debt by 2014. For the total non-financial public sector net debt is projected to rise from $91 billion to $169 billion over the same period – an increase of 86 per cent.

Over the forward estimates period the ratio of state and territory net debt to revenues for the non-financial public sector are expected to increase from 49 per cent in 2010 to 79 per cent in 2014.

This trend raises questions about the sustainability of the states' borrowings, and whether the growth in net debt will place an undue call on revenues compulsorily acquired from taxpayers especially if economic conditions deteriorate sometime over the next few years.

To be sure, these questions must be balanced against the uses of the borrowed funds by governments. State and territory premiers, chief ministers and treasurers have indicated that the proceeds of borrowed funds will be expended on record amounts of public infrastructure investment.

In general terms, incurring debt for public infrastructure that yields insufficient net benefits to the community would tend to reduce future economic productive capacity. With the private sector possessing a greater generalised capacity to build large-scale infrastructure more efficiently and quickly, the implied boom in government capital spending may entail lost economic opportunities elsewhere.

Consistent with this, the lack of published cost-benefit analyses of major government projects gives cause for concern regarding the value for money to be derived from debt-financed public infrastructure spending.

The economic impacts of the planned capital investments by state governments are also influenced by their timing. The implied substantial increase in infrastructure spending, financed by debt, is projected to occur during a period when the economy will be presumed to be growing strongly and as the private sector seeks to escalate their investment plans.

The ensuing competition for skilled labour and materials may strengthen inflationary pressures in the economy, putting additional upward pressure on interest rates which in turn risks crowding out relatively more efficient private sector projects and ventures.

The reasons for subnational fiscal rules

Over the past thirty years greater recognition has been accorded to the need for rule-based approaches in the conduct of fiscal policy. As will be discussed below, this has translated into a range of constitutional provisions, legislation and policy guidelines introduced by subnational (regional and local) governments across the OECD to check the spending, taxing and borrowing activities of governments.

Why are such approaches deemed to be necessary in the first place?

Theoretical developments in the public choice approach to economics provide the most comprehensive explanation regarding the desirability of fiscal rules. It is conceived that in democratic societies there is a tendency for politicians and certain voters to prefer budget deficits over balance or surplus. This phenomenon is centred about a fundamental asymmetry between the political implications of government expenditure and taxation.

As explained by the founder of the public choice school, James M. Buchanan:

'Beneficiary groups, recipients of direct transfers or of governmentally financed programs, tend to be concentrated, organised, 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.'[11]

The fiscal interests of future generations of taxpayers, including children and the unborn, are also not sufficiently represented in the political system in the present. This provides an incentive for political representatives to borrow to finance government spending, and shift the responsibility for repaying the principal and interest of public debt to future taxpayers who cannot politically consent to the borrowing activity.[12]

Even if politicians wish to maximise current and future economic welfare, including by keeping government small and taxes low, they may be unable to credibly commit to a program of fiscal austerity into the future. This phenomenon is known in the economics literature as the 'time inconsistency' problem.

For example, assume the existence of two political parties – a fiscally responsible incumbent, and a spendthrift opposition – vying for voter support in advance of an election. With the opposition gaining widespread electoral favour because of its spending promises, the incumbent finds itself under intense political pressure to forgo its austerity program and increase spending to regain lost support. Motivated by the desire to retain office in a politically competitive environment, the incumbent effectively relaxes its fiscal policies transitioning the government budget into deficit.

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

[12] To again quote Buchanan, 'The most elementary prediction from public choice theory is that in the absence of moral or constitutional constraints democracies will finance some share of current public consumption from debt issue rather than from taxation and that, in consequence, spending rates will be higher than would accrue under budget balance.' James M. Buchanan, Charles Rowley and Robert D. Tollison, 1987, 'Budgetary Bias in Post-Keynesian Politics: The Erosion and Potential Replacement of Fiscal Norms', in *Debt and Taxes*, vol. 14 of *The Collected Works of James M. Buchanan*, Liberty Fund, Indianapolis, p. 471.

In other words, the possibility of a government being unable to retain fiscal integrity on a consistent basis also justifies the need for rules to enforce budgetary discipline both in the present and future.

Apart from the potential crowding out effects of budget deficits and public indebtedness, and the adverse efficiency consequences of tax-and-spend fiscal profligacy, there are additional conditions that may call for the establishment of fiscal rules at lower levels of government.

One of the key economic justifications for federal systems of government is that the actual or potential exit of scarce labour and capital from given jurisdictions will encourage subnational governments to provide fiscal packages of taxes and spending consistent with the preferences of citizens.[13]

However, often in practice 'the decision to move ... is based on a *package* of conditions, of which taxes are only one condition. If the other conditions are favorable, few people will change their behavior unless the increase in taxes is extraordinarily high.'[14] The existence of relatively weak Tiebout-exit impulses in a federal system provides a rationale for fiscal rules by state (and local) governments.

In addition, the limitations of macroeconomic policies in promoting economic growth and market productivity – as evidenced both in Australia and across the OECD in recent times – tend to become magnified at the lower levels of government.

It is possible that state governments do not fully account for the national economic implications of their fiscal decisions. For example, 'higher public spending could have adverse spillover effects on the rest of the economy. Financed through subnational borrowing, it may affect lending conditions for other public and private agents. Financed by higher taxes, it can undermine incentives to work and invest.'[15]

In federal systems of government there may be an implicit expectation that the central government would bail out lower levels of government during periods of economic difficulty.[16] In countries with a significant degree of vertical fiscal imbalance, such as Australia, states also have a more limited capacity to repay the proceeds of their public sector debt.

In the absence of fiscal rules concerning the management of budgets and the ability to borrow on capital markets, there may be a heightened risk of moral hazard in the form of undisciplined fiscal conduct at the subnational level.[17]

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[13] Charles M. Tiebout, 1956, 'A Pure Theory of Local Expenditures', *The Journal of Political Economy* 64 (5): 416-424.

[14] William A. Niskanen, 2005, 'Constitutional Limits to State and Local Spending', Address to University of Wisconsin Robert M. La Follette School of Public Affairs, http://www.lafollette.wisc.edu/publicservice/spending/niskanenspending.pdf (accessed 21 April 2010).

[15] Isabelle Joumard and Per Mathis Kongsrud, 2003, 'Fiscal Relations Across Government Levels', *OECD Economic Studies* 36 (1), p. 198; Robert Carling, 2007, 'Building up to a national impact', The Australian Financial Review, 1 August.

[16] This effectively occurred in the Australian context during the recent global financial crisis, with the commonwealth significantly increasing grant payments to states and local councils (and thereby raising additional federal government debt). These intergovernmental transfers, counted by states and councils as revenue, served to reduce the extent of budget deficits reported by jurisdictions.

[17] Financial markets may play an important role in monitoring the fiscal sustainability of subnational jurisdictions with, for example, credit agencies publicly rating Australian state and territory semi-government bonds on issue. To some extent, financial markets

Despite these reasons for fiscal rules some objections have been raised that rules governing the conduct of tax, expenditure and borrowing policies may violate democratic principles. However on closer inspection such objections cannot be sustained (Box 3).

could substitute for sub-national fiscal monitoring mechanisms by imposing higher borrowing costs in cases of imprudent fiscal policy. Douglas Sutherland, Robert Price and Isabelle Joumard, 2005, op cit.

Box 3: Are fiscal rules undemocratic?

A key objection leveled against the introduction and maintenance of fiscal rules, such as tax-and-expenditure limitations and public debt caps, is that they are inconsistent with widely accepted foundations of political democracy.

An education policy think tank based in Washington DC criticised Taxpayer Bill of Rights (TABOR) fiscal rules on the basis that 'they amount to the citizens of today denying the citizens of the future the chance to have different opinions about how much public spending is desirable (unless that amount happens to be less than spending today).'

Meanwhile, a Facebook group called 'Student Voices against TABOR' suggested that a recent fiscal rule proposal in the US state of Mainer was undemocratic because it 'enables a minority rule by requiring a 2/3 vote on any kind of changes to TABOR within the state legislature.'

The implicit alternative – that fiscal policy should not be subject to institutional restraint, but instead be entirely left to the discretion of elected politicians – has long been recognised as a potential recipe for outright fiscal exploitation, at least of certain minority groups, by governments.

The seventeenth-century political philosopher David Hume described the need for institutions to define and limit the roles and activities of government on the following basis:

'in contriving any system of government, and fixing the several checks and controls of the constitution, every man ought to be supposed a knave, and to have no other end, in all his actions, than private interest. By this interest we must govern him, and, by means of it, make him, notwithstanding his insatiable avarice and ambition, co-operate to public good. Without this … we shall in vain boast of the advantages of any constitution, and shall find, in the end, that we have no security for our liberties or possessions, except the good-will of our rulers; that is, we shall have no security at all.'

Institutional frameworks have long been adopted to channel government policies in ways that promote the interests of individuals and the community alike.

Fiscal policies in Australia and other Westminster countries are already mediated by rules such as the constitutional assignment of governmental powers, presentation of annual budgets and regular financial reports to parliament and the general public, parliamentary approval of budgetary appropriations, and the maintenance of parliament budget scrutiny committees. These institutions maintain widespread support throughout the community, and are viewed as essential in promoting democratic accountabilities.

Additional fiscal rules that concern the use of, including approved growth in, certain fiscal aggregates are consistent with existing democratic institutions that seek to protect individuals from the arbitrary exercise of coercive government interference. As explained above in the main text, stronger fiscal rules also seek to ameliorate the economically-damaging biases toward budget deficits and large public debt in democratic systems of government. To be sure, fiscal rules are invariably self-imposed by governments themselves or ratified through popular referenda. In this context, future governments could seek to alter or repeal the provisions of fiscal rules, subject to the endorsement of the majority of the voting public.

Source: Kevin Carey, 2006, 'Spending Limit Silliness', The Quick and the Ed blog, http://www.quickanded.com/2006/10/spending-limit-silliness.html (accessed 21 April 2010); David Hume, *Essays Moral, Political and Literary*; Roger Kerr, 2004, 'The Fiscal Responsibility Act: A Stocktake', Speech presented to Conferenz 8th Annual Public Sector Finance Forum, http://www.nzbr.org.nz/documents/speeches/speeches-2004/040923_fiscal_responsibility.pdf (accessed 21 April 2010); 'Student Voices against TABOR' Facebook website, http://www.facebook.com/group.php?gid=2205199534 (accessed 21 April 2010).

Subnational fiscal rules: Design and performance in an international context

For the purpose of this paper a fiscal rule can be defined as a permanent constraint on fiscal policy in terms of an indicator of fiscal performance.[18] As explained above such constraints are motivated by the need to instill greater discipline on the use of fiscal instruments by policymakers, which in turn should lend greater credibility to fiscal policies from the perspective of the general community.

Design features of fiscal rules

Fiscal rules, whether applied by central or subnational governments, can be distinguished from each other on the basis of several defining characteristics. First, rules are instituted to constrain specific fiscal aggregates including:

- Budget balance rules which may address the achievement of overall budget balance between government revenues and expenditure for each fiscal year, or a structural or cyclically adjusted balance, or balance 'over the economic cycle'
- Debt rules which seek to maintain a limit on, or target for, public debt levels (either in absolute terms or as a percentage of gross domestic product), or which obligate policymakers to borrow for certain purposes such as capital investments
- Expenditure rules may set limitations on total or recurrent government spending either in absolute terms, growth rates or as a percentage of GDP
- Revenue rules aim to establish either ceilings on revenues in absolute terms, or limits on allowable revenue inflows in terms of growth rates or as a share of the economy.[19]

These numerical targets may be accompanied by procedural changes to budget preparation and presentation with the objective of enhancing transparency, accountability and sound fiscal management.[20]

The sectoral coverage or comprehensiveness of fiscal rules represents another key ingredient in the design of these institutional frameworks. Fiscal rules should be based on indicators that are applied across as many institutional sectors of government as possible. This diminishes the incentive for policymakers to shift additional fiscal activities to sectors not subject to a non-comprehensive rule.

Fiscal rules may also be differentiated on the basis of whether they are enshrined in constitutional or statutory legislative provisions, or specified as a government policy. It is generally agreed that fiscal rules should be inserted into constitutions wherever possible, as it

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[18] George Kopits and Steven A. Symansky, 1998, *Fiscal Rules*, International Monetary Fund Occasional Paper No. 162, p. 2.
[19] International Monetary Fund, 2009, 'Fiscal Rules – Anchoring Expectations for Sustainable Public Finances', Fiscal Affairs Department, p. 5.
[20] Teresa Ter-Minassian, 2007, 'Fiscal Rules for Subnational Governments: Can They Promote Fiscal Discipline?', *OECD Journal on Budgeting* 6 (3): 1-11.

increases the political costs of rule violation as well as reduce the ability of a legislature to repeal the rule at a later date.[21]

Fiscal rules are likely to be more effective if governments are unable to waive their application and thus avoid fiscal constraints, except in extraordinary circumstances such as natural disasters.[22]

A regime of effective sanctions or penalties should also be applied in the event of non-compliance with a given fiscal rule. Associated with this is the need to monitor the extent of compliance by the rule-bound government, with for example an independent body made responsible for monitoring compliance with the rule and with the underlying accounting and procedural standards.[23]

In effect, a useful checklist for the design and evaluation of fiscal rules may include the following considerations:

- Broad scope: Does the rule have a broad scope, or does in focus on a small part of the budget so that it does not address the overall fiscal health of a government?
- Few and high-hurdle escape clauses: Are legislators permitted to waive the rule for any reason, or are there strict requirements for waiving a rule?
- Limited accounting discretion: Does the rule anticipate inevitable attempts to circumvent it through the creation of new spending or revenue categories?
- A credible enforcer: Is the individual or group charged with enforcing a rule going to be a faithful arbiter, or is the enforcer likely to have an incentive to permit violations?
- Limited enforcement discretion: Does the rule give the enforcer clear guidelines in the event of violations, or is the rule vague enough that violations can be ignored with creative interpretations?
- Rule embedded in a constitution: Is the well-designed rule embedded in a constitution, thereby creating a 'lock-in' effect and also increasing the political costs of violations?[24]

It is these principles of holistic fiscal rule design, implementation and enforcement which could prove to be beneficial in the development of stronger fiscal rules for Australia's state and territory governments.

[21] David M. Primo, 2010, 'Making Budget Rules Bite', George Mason University Mercatus Center, Paper No. 72, p. 3. However, as discussed below, there are certain issues which may reduce the degree of 'lock-in' of fiscal rules embedded in Australian state constitutions.
[22] As stated by Primo, 'as states do not have militaries … they ought to have no escape clause in their budget rules, except perhaps an exceptionally high voting threshold (say, 90 percent) that could trigger a waiver of the rule in truly unique circumstances.' Ibid, p. 2.
[23] George Kopits and Steven A. Symansky, 1998, *Fiscal Rules*, International Monetary Fund Occasional Paper No. 162, p. 19.
[24] David M Primo, 2010, 'Making Budget Rules Bite', George Mason University Mercatus Center Policy Brief No. 72.

Subnational fiscal rules in the Anglosphere

In addition to a mix of reliance on financial markets and fiscal coordination between levels of government, subnational governments have practically resorted to implementing their own rules to promote fiscal discipline.

The following section summarises the experience of selected fiscal rule regimes, pertaining to recurrent revenues and expenditures, applied by subnational jurisdictions in the mature Anglosphere federations of Australia, Canada and the United States. The following examples illustrate the benefits of fiscal rules in enhancing budgetary enforcement in some cases, and limitations caused by fiscal rules which do not neatly adhere to the criteria for good rule design and enforcement in others.

Australia

In Australia, the eight states and territories have adopted a variety of legislative mechanisms and government policies in an attempt to promote more sustainable fiscal outcomes (Table 1).

Generally speaking, the states have outlined a range of financial management principles affecting a broad range of fiscal aggregates, often applied within the context of medium term policy strategies, including the general government sector budget balance and taxation.

A number of jurisdictions complement these principles-based fiscal rules by defining a set of numerical fiscal targets. However the extent to which targets are applied vary by state and territory.

Table 1: State and territory government fiscal responsibility legislation and policies

Jurisdiction	Legislative or policy framework
New South Wales	*Fiscal Responsibility Act 2005* specifies medium and long term fiscal stability and debt targets; and outlines fiscal policy principles of budget surplus, consolidated net services costs and managing public sector employee costs, integenerational equity, and maintenance (or increasing) general government net worth.
Victoria	*Financial Management Act 1994* outlines principles of sound financial management including prudent financial management risk; ensuring taxation stability and predictability; tax system integrity; intergenerational equity; and disclosure of financial information.
Queensland	*Financial Accountability Act 2009* requires state treasurer to table a 'charter of fiscal responsibility.' Current charter includes principles of fiscal sustainability, competitive tax regime, and maintaining the state balance sheet; and targets applicable to each principle.
Western Australia	*Government Financial Responsibility Act 2000* applies financial principles and targets relating to public sector net worth; general government operating surplus; net interest costs; growth in own-purpose expenditure; and a fair and efficient taxation system.
South Australia	Fiscal policy targets including general government net operating balance; net financial liabilities to revenue ratio; effective tax regime; value for money services; fully funded superannuation liabilities; AAA credit rating; and borrowing to invest on commercial terms.
Tasmania	*Charter of Budget Responsibility Act 2007* includes principles of sound fiscal management such as transparent and accountable fiscal reporting; efficient, effective and sustainable resource use; impact on future generations; spending and taxation to promote equity, stability and predictability; and prudently managing risks.
Australian Capital Territory	*Financial Management Act 1996* requires government to report on short- and long-term financial objectives. Current fiscal objectives include achieving net operating surplus; maintain AAA credit rating; manage debt prudently; fully fund superannuation liabilities; maintain quality services; and tax revenue at sustainable levels.
Northern Territory	*Fiscal Integrity and Transparency Act 2006* outlines principles of sound fiscal management and public reporting of fiscal performance.

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

New South Wales

After gaining office in 1988, the Nick Greiner-led Coalition government established a five-year fiscal strategy which set out objectives such as the containment of growth in recurrent payments and public sector debt, and reducing the state's tax severity.

The Fahey Coalition government in late 1994 attempted, but narrowly failed, in its attempt to secure legislation amending the state constitution so as to require balanced budgets. The *State Debt Control (Balanced Budgets) Bill 1994* sought to legislate against budget deficits, except in exceptional circumstances such as a natural disaster.

A year later a new Labor government, led by Bob Carr, introduced the *General Government Debt Elimination Act 1995* with a focus on producing a budget surplus and reducing state debt. It included a short term objective of securing 'sustainable' general government budgetary surpluses and a long term target of eliminating net debt in the general government sector by 2020.

In 2005 the state government obtained passage of the *Fiscal Responsibility Act* which prescribes a range of fiscal sustainability principles, as well as a range of numerical targets to be met (Table 2).

Table 2: Targets specified in *NSW Fiscal Responsibility Act 2005*

Fiscal target 1 (medium term)	Reducing the level of government net financial liabilities, as a proportion of GSP, to 7.5 per cent (or less) by 30 June 2010
Fiscal target 2 (medium term)	Maintaining general government net debt, as a proportion of GSP, at (or below) its 30 June 2005 level (0.9 per cent of GSP)
Fiscal target 3 (long term)	Reducing the level of general government net financial liabilities, as a proportion of GSP, to six per cent (or less) by 30 June 2015
Fiscal target 4 (long term)	Maintaining underlying general government sector net debt, as a proportion of GSP, at (or below) its 30 June 2005 level (0.8 per cent of GSP), unless an increase in net debt is required to reduce one or more components of general government net liabilities
Fiscal target 5 (long term)	Eliminating total state sector unfunded superannuation liabilities by 30 June 2030

Source: John Wilkinson, 2010, 'Australian Federal and State Budgets - An Overview', NSW Parliamentary Library Research Service, Briefing Paper No. 2/10.

According to the 2010-11 NSW budget papers the government has failed to meet its first two targets, as the net financial liabilities-to-GSP ratio rose to 11.5 per cent by 2009-10 and net debt-to-GSP stood at 2.5 per cent.

Although no estimates for 2014-15 were available at the time of writing it would also appear that the state government would find it difficult to adhere to fiscal target 3, since the ratio of general government net financial liabilities to GSP is projected to remain at ten per cent in 2013-14.

Since 1977 the NSW government has applied ‘rate pegging’ restrictions on the ability of local governments to acquire municipal rates revenue. Under Section 506 of the Local Government Act 1993 a limit is set on the percentage increase in total general income that councils can raise from particular rates and charges. This is known as the ‘rate-peg’ percentage and is specified by the Minister for Local Government on an annual basis, with the Minister also having discretion to allow councils to temporarily exceed the rate-peg percentage.[25]

Victoria

In response to the structural budget deficit and unsustainable public sector debt accumulated under the Labor Cain and Kirner governments, the newly-elected Kennett Coalition government in 1992 adopted a strategy to return Victoria to a state of fiscal sustainability.

Initially, a three-year strategy was specified based on expenditure reductions, targeting budgetary balance by 1995-96 and public sector debt reductions. A current account budget surplus equivalent to 0.8 per cent of Victorian GSP was achieved in 1994-95, a year earlier than established under the strategy.

From 1995-96 to 1998-99, the government established a host of fiscal targets including:

- achievement of, by no later than 1998-99, a sustainable current account surplus to cover depreciation of the budget sector capital stock without increasing overall tax levels;
- maintenance of budget sector investment on infrastructure from public and private sources averaging about 1.25 per cent of GSP; and
- application of net proceeds of privatisation to debt reduction.

In addition, longer term objectives were announced including reducing state debt and debt servicing ratios to levels consistent with the restoration of the state's AAA credit rating, and to better align Victoria's tax effort ratio to the Australian state average.[26]

In 2000 the Bracks Labor government introduced the *Financial Management (Financial Responsibility) Act*, obligating the government to operate in accordance with broad financial management principles including the ‘prudent management of risks,’ and the pursuit of expenditure and revenue policies consistent with stable and predictable levels of taxation burdens.

In each budget a set of short and long term fiscal strategies were to be made publicly available. In the last budget of the Brumby government, short term targets such as an operating budgetary surplus of at least $100 million and maintenance of an AAA credit rating were specified. While the previous government adhered to many of its self-imposed fiscal and budgetary principles, concerns had been raised about budget projections of ratcheting levels of net debt especially given increasing evidence of cost blowouts on numerous major projects.

[25] Productivity Commission, 2008, *Assessing Local Government Revenue Raising Capacity*, Research Report, Canberra.
[26] National Commission of Audit, 1996, Report to the Commonwealth Government, AGPS, Canberra.

The new Baillieu Coalition government has announced a range of strengthened fiscal priorities and targets, including principles concerning the use of borrowings.

Queensland

Until recently, state governments in Queensland over the past two decades or more adhered to a set of clearly defined fiscal strategies as follows:

- maintenance of a budgetary surplus;
- social infrastructures are to be funded from recurrent revenue sources, and debt can only be raised for assets that can generate income to service the debt;
- full funding of long term liabilities such as superannuation and workers compensation;
- revenues are to be restrained, including the maintenance of Queensland as a 'low tax' state.

While these policy objectives were not necessarily enshrined in legislation, at least prior to the late 1980s, it has been observed that successive governments had largely met their publicly announced fiscal commitments.

After the election of the Beattie Labor government in 1998, the *Financial Administration and Audit Act (Qld) 1977* was amended to require the government to prepare a Charter of Social and Fiscal Responsibility, setting out the broad social and fiscal objectives of the government and performance measures against these objectives.

A new *Financial Accountability Act 2009* was enacted by the Bligh government requiring the state treasurer to table in the Legislative Assembly a Charter of Fiscal Responsibility based on three overarching themes (Table 3).

Table 3: Queensland Charter of Fiscal Responsibility

Objective	Principle
Fiscal sustainability	• In the general government sector, meet all operating expenses from operating revenue • Growth in own-purpose expenses in the general government sector to not exceed real per capita growth • Achieve a general government net operating surplus as soon as possible, but no later than 2015-16
Competitive tax regime	• Maintain a competitive tax environment for business
Managing the state's balance sheet	• Stabilise net financial liabilities as a proportion of revenue in the non-financial public sector

Source: Queensland Treasury website.

With currently the worst fiscal position of all the states and territories, it is apparent that the Queensland government has fallen short of meeting a number of critical fiscal policy objectives, including containing expenses in real per capita terms.

Canada

Most Canadian provinces have enacted a regime of fiscal rules since the early 1990s, with the passage of legislation designed to maintain balanced budgets and debt limitation.

Alberta

In 1993 the fiscally stricken western province of Alberta, with the largest oil reserves outside of the Middle East, introduced the *Deficit Elimination Act* (DEA) which underpinned a plan by the Klein Progressive Conservative government to reduce the provincial budget deficit by 1996-97.

The DEA required that the amount of current year expenditure should be no greater than the average amount of resources revenue (from oil and other commodities) during the five preceding years. Any amount above that average was to be used to reduce Alberta's public debt. The rationale for this fiscal rule was to ensure that resource revenue windfalls could not finance new government spending.[27]

With Alberta's budget in balance by 1995,[28] the DEA was supplanted by the *Balanced Budget and Debt Retirement Act* (BBDRA). The BBDRA outlined a schedule for the repayment of provincial debt over a period of 25 years, and prohibited the province from running an annual budget deficit.

The spending rule was changed under the BBDRA, permitting the government to base current year spending as the lower of the average amount of resource revenue available during the preceding five years (as under the DEA) and 90 per cent of the amount forecast for the current year.

The *Alberta Taxpayer Protection Act* was introduced in the same year. The Act included a referendum requirement for the introduction of a retail sales tax in the province.

In light of a shortfall of resource revenues, which would have necessitated spending cuts under the DEA or BBDRA, Alberta enacted the *Fiscal Responsibility Act* (FRA) in 1999. The FRA incorporated an ‘economic cushion’ into the budget parameters of 3.5 per cent of forecast revenues. This enabled the budget and program spending to be quarantined from unexpected shortfalls in revenue and the more stringent demands of the no-deficit rule of the BBDRA.

After 2001 concerns switched to the budgetary implications of a surge in commodity prices which, in turn, led to a significant increase in resource revenues and concerns that the provincial government might base future spending on the basis of a temporary uplift in revenue.

[27] Ronald D Kneebone, 2006, ‘From Famine to Feast: The Evolution of Budgeting Rules in Alberta’, *Canadian Tax Journal* 54 (3): 657-673.
[28] This outcome has been not only attributed to the enactment of the DEA fiscal rules, but also to discretionary reductions in government expenditure of 20 per cent as well as privatisations of state-owned assets.

This led to the amendment of Alberta's fiscal rule settings through the *Financial Statutes Amendment Act* in 2003. The two key stipulations under the Act were:

- beginning with the fiscal year 2004 budget, the amount of resource revenue used to finance government spending was capped at $C3.5 billion
- a new Alberta Sustainability Fund was created, with resource revenues in excess of $C3.5 billion siphoned off into the Fund. The amount of revenues to be stored in the Fund was initially capped at $C2.5 billion.

Further legislative amendments in following years lifted the fixed base spending amount from $C3.5 billion to $C4.0 billion, and to $C4.75 billion.

Currently Alberta is facing a widening budget deficit problem, with a budget shortfall of $C4.75 billion in the current fiscal year compared to $C3.62 billion from the previous year. However, according to current projections the province is to eliminate its budget deficit by 2012-13, a year before major provinces such as British Columbia and Quebec.[29] It is projected that this improved outcome within three years will result from an improvement in royalty revenues, as well as efforts by the provincial government to draw down the Sustainability Fund.

British Columbia

The province of British Columbia introduced the *Taxpayer Protection Act* in 1991. It included a five-year balanced budget plan, a tax freeze on specific items and a prevention of new taxes, limitations on expenditure growth, and a debt reduction plan. However, the Act was repealed within a year of its enactment following a general election in the province.[30]

In 2000 the province introduced the *Balanced Budget Act* (BBA). It included a plan for a balanced budget by 2004-05, with the rule only to be relaxed in emergency and/or unexpected circumstances or for significant reductions in revenue. A feature of the BBA was the enactment of a penalty of a 20 per cent reduction in cabinet salaries for one year if fiscal targets were not met.

A Liberal government was elected a year later and repealed the BBA in favour of the Balanced Budget and Ministerial Accountability Act (BBMAA). It set out a short term fiscal objective that the actual deficit could not exceed the budgeted deficit in 2002-03 and 2003-04, with a prohibition against forecast budget deficits commencing in 2004-05.

The BBMAA required the withholding of 20 per cent of ministerial salaries, which are only paid when certain targets are met:

- half of the salary withheld is returned if a forecast deficit is not exceeded, a forecast balanced budget is met, or 50 per cent of a forecast surplus is achieved

[29] Reg Curren, 2010, 'Alberta Deficit to Widen to C$4.75 Billion Before Surplus Seen', http://www.businessweek.com/news/2010-02-09/alberta-deficit-to-widen-to-c-4-75-billion-before-surplus-seen.html (accessed 6 December 2010).

[30] Suzanne Kennedy and Janine Robbins, 2003, 'The Role of Fiscal Rules in Determining Fiscal Performance', Canada Department of Finance, http://www.fiscalreform.net/FiscalRoundTable/background_papers/countries/canada/the_role_of_fiscal_rules_in_determining_fiscal_performance.pdf (accessed 6 December 2010).

- the remainder of the salary withheld is returned if either expenditure estimates are not exceeded, revenue forecasts are met, or actual results meet or exceed expected results for individual ministerial responsibilities.

The government of British Columbia relaxed the provisions of the BBMAA last year to allow for deficit budgeting. Specifically, the prohibition against budget deficits was not to apply to the main estimates for the 2009-10 and 2010-11 fiscal years.

The government has provided a verbal undertaking that at the end of the two-year period, the authorisation to present budget deficits would be repealed. In addition, the loss of 20 per cent of annual salaries of cabinet ministers would continue to apply.[31]

Ontario

Under the premiership of Progressive Conservative leader Mike Harris, Ontario enacted the *Taxpayer Protection Act* and *Balanced Budget Act* (BBA) in 1999.

The BBA required that expenditure in a given fiscal year not exceed revenues in that year, plus the net accumulated surplus from the previous three years. This balanced budget rule applied to the 2001-02 fiscal year onwards. Deficits are only permitted in extraordinary circumstances, such as war or natural disaster, or a revenue decline of at least five per cent for a reason other than a tax rate reduction.

If a deficit greater than one per cent of revenue occurs in a year, or if a deficit less than one per cent is not offset in the following year, ministerial salaries were to be cut by 25 per cent. In the event of ongoing deficits, salary reductions of 50 per cent are stipulated.

The *Taxpayer Protection Act* also prohibited an increase in an existing tax (including personal and corporate income taxes, retail sales tax, and gasoline and fuel taxes), or the creation of a new tax, unless approved by a popular referendum.

With a change of government, the *Fiscal Transparency and Accountability Act* was introduced in 2004 which repealed the previous suite of fiscal rules. Elements of the Act included planning for an annual balanced budget, a debt-to-GDP rule and provisions for multi-year fiscal plans.

In the first term of Liberal government under Dalton McGuinty, a Health Premium Tax of up to $900 per annum for health care services was introduced without subjecting the proposal to a referendum as required under taxpayer protection legislative provisions. The *Taxpayer Protection Act* was amended was amended to allow for the implementation of the health tax, with this decision later upheld by a court ruling.

Other violations of the Act, such as introducing green levies and exempting municipal governments from its provisions, have been subsequently introduced.

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[31] 'B.C.'s amended balanced budget law to allow 2 years of deficits', http://www.cbc.ca/canada/british-columbia/story/2009/02/09/bc-legislature-budget-deficit-vote.html, (accessed 6 December 2010).

United States

The most comprehensive experiments in subnational fiscal rules have been conducted in the United States. An increasing number of jurisdictions have combined balanced budget rules with tax-and-expenditure limitations (TELs).

A TEL is a constitutional or statutory provision that limits the growth of government expenditures or revenues, generally either to a ratio of population growth plus inflation growth or economic growth, and in some instances allows taxpayers to approve or reject spending or tax increases through a referendum process.

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 current TELs are constitutional provisions and the other half are statutory by nature.[32]

California

The most populous state in the US, California, has experimented with fiscal rules for nearly four decades. Indeed, it may be reasonably argued that the origins of the modern US tax revolt can be traced to the efforts of former state governor (and, later, US president) Ronald Reagan in the early 1970s to limit the growth of California's public sector (Box 4).

Concerned about the impact of rising property valuations in California driving increases in property tax collections, particularly affecting elderly residents and others on fixed incomes, led to a campaign during the mid- to late-1970s to reduce the burden of property taxes.

Businessman Howard Jarvis and political activist Paul Gann gathered sufficient signatures on a petition for a ballot to cap property tax rates at one per cent of the market value of a residence, down from 2.5 per cent at the time. It also restricted annual increases of assessed values of real property to a maximum of two per cent per year.

This bundle of measures, known as Proposition 13, was approved by Californian voters in 1978 with a 65 per cent majority. This measure provided for an immediate property tax reduction of $6 billion and, while it has been subjected to many ballot revisions since, continues to deliver a measure of tax relief to state residents.[33]

[32] Bert Waisanen, 'State Tax and Expenditure Limits – 2008', National Conference of State Legislatures, http://www.ncsl.org/IssuesResearch/BudgetTax/StateTaxandExpenditureLimits2008/tabid/12633/Default.aspx (accessed 27 April 2010).

[33] Michael J New, 2008, '13's Going on 30', National Review, http://www.nationalreview.com/articles/224669/13s-going-30/michael-j-new (accessed 20 December 2010).

Box 4: The movement that 'The Gipper' created: Proposition 1 of 1973

Upon election as Republican governor of California in 1967, Ronald Reagan was faced with a sizeable state budget deficit left behind by the Democrat gubernatorial administration of Pat Brown. As Reagan described it, 'California was virtually insolvent … The state government was spending $1 million a day more than it was collecting.'

Against a hostile Democrat-majority legislature opposed to spending cuts, Reagan was initially forced to raise taxes by US$800 million to balance the budget. Despite path-breaking state welfare reforms that reduced the numbers of welfare receipients, the Californian budget remained under significant pressure.

In 1972, Governor Reagan commissioned a Task Force on Tax Reduction to investigate ways to deliver fiscal sustainability for California. One of the key findings of the Task Force panel, which included economists such as Milton Friedman and James Buchanan, was that public sector expenditure had outpaced state revenues and economic growth and that governmental spending should be limited in accordance with tax 'income' received.

It was on this basis that Reagan put forward a ballot initiative to amend the California constitution so that the growth of government could be brought back under control. When presenting his proposal to the state legislature, Reagan stated that 'government must realise that it cannot indefinitely tax the people at constantly increasing levels without destroying the people's ability to support themselves and their families.'

Proposition 1 set a limit on state expenditure equal to the current ratio of state expenditure as a share of state income (estimated at 8.3 per cent in 1973), and required that spending to decrease by 0.1 per cent each year until it reached seven per cent, at which time the legislature (by two-thirds vote) could halt the annual reduction.

It was also required under Proposition 1 that future state budget surpluses be returned to the people in the form of tax refunds or reductions, except in circumstances to meet emergencies (as declared by the governor).

Against the background of fierce opposition from teacher unions and the main state public sector union, Proposition 1 failed narrowly attracting 46 per cent of the referendum vote held in November 1973. Nonetheless, Reagan's vision for constraining the growth of government set the stage for the future state tax-and-expenditure limitation movement across the US.

Source: Garin Burbank, 1993/94, 'Governor Reagan's Only Defeat: The Proposition 1 Campaign in 1973', *California History* 72 (4): 360-373; Steven Miller, 2006, 'TASC: Reagan's Gift to Nevada', Nevada Policy Research Institute, http://www.npri.org/publications/tasc-reagans-gift-to-nevada (accessed 20 December 2010); Michael New, 2004, 'Morning in California', National Review, http://www.nationalreview.com/articles/211036/morning-california/michael-j-new (accessed 20 December 2010); Ronald Reagan, 1973, 'Reflections on the Failure of Proposition #1', National Review, http://old.nationalreview.com/flashback/reagan200406080927.asp (accessed 20 December 2010).

A year later, another constitutional provision to constrain the Californian government was passed by voter initiative as an accompaniment to Proposition 13. Proposition 4, known as the 'Gann Limit,' imposed a ceiling on state and local expenditure at the level of population growth plus inflation. In the event that tax revenue growth exceeded that limit, the excess funds were to be returned to taxpayers.

Initially the Gann limit was effective in constraining government spending, with Californian taxpayers receiving a US$1.1 billion tax rebate in full in 1987 when revenue exceeded the budget limit. This was despite efforts by the then-Republican governor George Deukmejian to spend US$400 million of this amount on schools. Between 1980 and 1991, California's ranking in US state per capita expenditures fell from seventh to sixteenth.[34]

However subsequent amendments, strongly supported by public sector unions, have rendered the Gann limit virtually ineffective as a fiscal restraint. Proposition 98 of 1988 enabled schools to receive Gann limit refund revenues of up to four per cent of schools' minimum funding base.

Proposition 111 of 1990 weakened the original Gann limit even further, by dedicating 50 per cent of excess revenues to schools, exempting a range of appropriations from the limit (e.g., 'qualified' capital outlays and projects funded from gasoline taxes), and changing the limit of population growth plus inflation to an average of growth in state-wide personal income. The Gann limit was relaxed to be triggered over a two-year period, instead of the previous one.

While the Gann limit itself had some flaws, including the exclusion of non-taxes such as fees and fines from the assessable revenue base,[35] the long term fiscal consequences of weakening this rule are clear. Over the past two decades or so California has experienced 'boom-bust' budget cycles of exploding revenues and spending during periods of strong economic growth, followed by a collapse in revenues and emergency retrenchment in recessions (Figure 4).[36]

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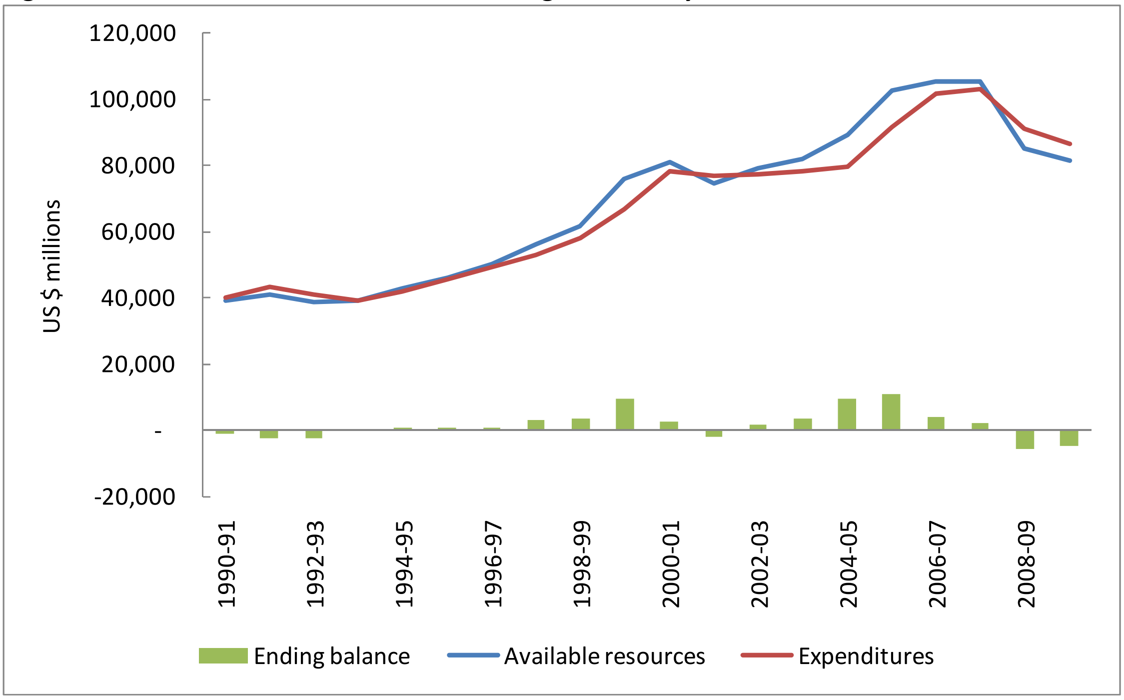
[34] Michael New, 2004, 'The Gann Limit Turns 25', http://www.cato.org/pub_display.php?pub_id=2871 (accessed 20 December 2010).

[35] For example, local governments in California have imposed infrastructure charges for new real estate developments similar to those applied by a number of states and local governments in Australia. It has been estimated that, in California, fees, new infrastructure and other mandated expenses add up to US$60,000 for each new home. In response to the significant increases in non-tax sources of revenue, a citizen-initiated constitutional amendment was passed in November 2010 requiring voters to approve new state levies and charges by a two-thirds majority.

[36] Michael J Boskin and John F Cogan, 2009, 'How California Can Get Its Groove Back', The Wall Street Journal, 29 September.

Figure 4: State of California General Fund budget summary



Source: State of California Budget Papers.

Expenditure growth has remained relatively unrestrained, with total spending increasing by 181 per cent from 1990 to 2008 (compared to a 167 per cent increase in revenues). According to estimates by Boskin and Cogan, if expenditure had increased in real per capita terms since the mid-1990s recession-level revenues plus reserves would have been more than sufficient to balance the state budget today.[37]

Yet, many analysts have described how public sector union pressure to increase recurrent spending has yielded perverse budgetary and policy outcomes for California.[38] In terms of education, which comprises 40 per cent of the state budget, California's public school teachers are the most highly remunerated in the US with pay and benefits about 35 per cent above the national average.

More generally, California has the highest number of state and local employees per capita with 486 per 10,000 US residents. Public sector union numbers in the state have grown by 37 per cent since 1990, and consume about one-third of the US$85 billion Californian budget in wages and pension benefits.

The state also has a total unfunded future liability of about US$110 billion in pensions and health-care benefits for its public sector employees, with pension benefits so generous that individuals could retire from their job in their early 50s and receive lifetime retirement benefits at 90 per cent of their final salary.

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[37] Michael J Boskin and John F Cogan, 2009, Ibid.

[38] For a summary, see Steven Greenhut, 2009, *Plunder! How Public Employee Unions are Raiding Treasuries, Controlling Our Lives and Bankrupting the Nation*, Forum Press, Santa Ara.

The budget has often reverted back into deficit despite a raft of tax hikes. As a consequence of rising expenditure, California has had to repeatedly raise income taxes, sales taxes, taxes on beer, wine, gasoline and cigarettes, and fees on motor vehicle registrations. Former governors have advocated imposing special taxes on snack foods, while a ballot initiative to legalise and tax marijuana failed in November 2010.

It has been estimated that Californian governments receive $US4,731 per resident from all taxes, or 14 per cent more than the average outside California. The top personal income tax and corporate tax rates, sales tax rate and gas tax rate are all at, or near the highest, of any state, and the top one per cent of the state's income earners pays almost half the income tax receipts. These tax policies have been cited as factors driving business investment and employment to low taxing US jurisdictions such as Texas which, for example, imposes no income taxes.

Amidst a new budgetary crisis, the former Republican governor Arnold Schwarzenegger put to referendum a proposal to establish a new 'rainy day fund' to smooth out the cycling inherent within the California state budget.

Proposition 1A of 2009 was to create a fund of up to 12.5 per cent of the budget, diverting three per cent of revenues during economic boom years into the fund which could only be spent during recessions (it was also permitted that the legislature could draw on the fund to pay for 'capital outlays').

In addition, a new fiscal limitation rule was proposed with revenue allowed to grow each year at the average rate of growth of tax receipts over the past decade, or at the rate of population growth plus inflation, whichever is greater. Revenues above that amount would be diverted into the reserve fund to be spent at a later date.

This rule, which was defeated by a popular vote of Californian residents, was far weaker than the 1978 Gann limit which imposed an annualised real per capita limit on expenditure.

Colorado

One of the more prominent TEL models in the US is the Colorado Taxpayer Bill of Rights (TABOR), which had been described approvingly by no less an authority than Milton Friedman as a 'Proposition 1 look-alike.'[39]

In 1992 Colorado voters approved the TABOR state constitutional amendment, found in Article X, Section 20 of the constitution. Under TABOR, growth in state and local expenditure and revenue increases are pegged to inflation plus population growth with any revenue collected in excess of the limit refunded to taxpayers. All tax increases must be approved by voters and that pre-existing TELs (passed in 1977 and 1991) cannot be diluted without voter approval.[40]

The operation of TABOR has been heralded as a factor contributing to an improvement in the state's fiscal performance. State revenues and spending grew about twice as fast in the ten

[39] Milton Friedman, 2004 'Freedom's Friend', The Wall Street Journal, 11 June.
[40] Michael J New, 2001, 'Limiting Government through Direct Democracy: The Case of State Tax and Expenditure Limitation', Cato Institute Policy Analysis No. 420.

years prior to TABOR passed as they have to 2005. State and local government expenditure as a share of gross state product fell from 16.4 per cent in 1992 to 15.6 per cent in 2002.[41]

From the introduction of TABOR more than $US3 billion in surplus revenue had been returned to taxpayers.[42] Under the fiscal rule regime, Colorado also reduced state income tax, sales taxes and other taxes such as the business property tax.

Contrary to protestations by a former Democrat governor that the reduced fiscal flexibility implied by TABOR would lead to an ‘economic Armageddon,’ Colorado improved its performance on a range of economic indicators (Table 4).

Table 4: Changes in Colorado economic rankings among US states

Indicator	Pre-TABOR (1980-1992) rank	Post-TABOR (1993-2006) rank
Population growth	13	3
Per capita income	18	9
Per capita income growth	34	6
Economic growth	26	3
Per capita income	12	8

Source: Todd Hollenbeck, 2008, ‘TABOR: What Was Said vs. What Really Happened’, Independence Institute.

Despite its success, there has been some weakening of the TABOR provisions in recent years. In 2005 Colorado voters approved Referendum C, which allowed the state to retain and spend $US3.7 billion in surplus revenue above the TABOR limit instead of rebating that money to taxpayers. This decision has put at risk the long term integrity of TABOR by relaxing the base line on which the state calculates the allowable growth in spending.

Further, after the five-year TABOR suspension period expires, annual growth in state revenue is recapped at the highest level of revenue received in any one year during this five-year period (adjusted for changes in population and inflation). The new limit will continue to rise with increases in population and inflation, representing a hidden tax increase on Colorado taxpayers.

From 2006 to 2010 it is estimated that Colorado taxpayers missed out on $US3.6 million in tax rebates as a result of the 2005 voter approval of Referendum C. With the TABOR revenue limit now anticipated to return to a higher level in 2011, it is projected that taxpayers will not receive another $US1.2 million in rebates in 2011 and 2012 compared to the pre-Referendum C scenario.[43]

One of the rationales for Referendum C was that it would ameliorate the worst manifestation of the so-called ‘ratchet effect,’ in which the TABOR limit resets to a new, lower amount if revenues decline, say, during a recession. It has been argued by the critics of TELs that this effect would obligate policymakers to reduce government expenditures to a new, permanent low.

[41] Ronald K Snell, 2005, ‘Nuts and Bolts of TABOR’, *State Legislatures* 31 (1): 24-25.
[42] It is estimated that between 1997 and 2002 Colorado taxpayers received $US3.2 billion in tax refunds from the state government. Michael New, 2009, ‘Opportunities for Taxpayer Protection in 2009’, *Inside ALEC* (April): 23-24. See also Barry W Poulson, 2004, ‘Tax and Spending Limits: Theory, Analysis, and Policy’, Independence Institute Policy Backgrounder No. IB-2004-E.
[43] Steve Stanek, 'Colorado's TABOR Suspension Ends; Revenue Limits Return', http://www.heartland.org/full/27949/Colorados_TABOR_Suspension_Ends_Revenue_Limits_Return.html (accessed 20 December 2010).

However, TABOR only restricts spending only if a legislature acquires additional revenue above the set limit.[44] The budgetary problems experienced by Colorado during the early 2000's were exacerbated by the voter-approved mandate Amendment 23 of 2000. This required K-12 school funding to increase by inflation plus one per cent from 2001 to 2011, and by inflation thereafter.

The education mandate in Colorado is required to be implemented regardless of economic conditions, placing pressure on other state government services to feed mandated increases in education expenditure.

Despite ongoing efforts by vested interests to compromise the effectiveness of TABOR, this type of TEL is still widely seen by fiscal experts as the best and most effective fiscal limit in the US today.

Florida

In November 1994 Florida voters approved a constitutional amendment designed by the state legislature to limit the growth of state revenues.

The amendment, contained in Section 1(e), Article VII of the Florida constitution, indicates that 'state revenue collected for any fiscal year shall be limited to state revenues allowed ... for the prior fiscal year plus an adjustment for growth.' Growth is defined as 'an amount equal to the average annual rate of growth in Florida personal income over the most recent twenty quarters times the states revenues ... for the prior fiscal year.'[45]

If the amount of revenues received are in excess of the limit they are transferred to a Budget Stabilization Fund until that fund reaches ten per cent of the previous year's revenues, after which excess revenues are refunded to taxpayers. The revenue limitation itself can be increased by a two-thirds vote of the state legislature.

This rule operates in conjunction with other fiscal rules including an *ex-ante* balanced budget requirement, and a debt limitation of 50 per cent of the tax revenues for the preceding two years. The state constitution prohibits Florida from imposing an income tax, and there also exists a limit upon property taxation.

Despite this, a number of American fiscal scholars have assessed that the Floridian revenue limitation is largely ineffective. The following problems have been identified:

- The intended effect of the revenue limit in constraining the growth of government is weakened during periods of rapid economic growth, which in turn allows for strong growth in revenue and spending.
- Since the early 1990s, the base of previous year revenues to determine the overall revenue limit has been increasing strongly thus rendering the cap as ineffective in constraining the growth of state government.

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[44] Todd Hollenbeck, 2010, 'Referendum C: The Wrong Solution for the Wrong Problem', Independence Institute.

[45] Constitution of the State of Florida, http://www.leg.state.fl.us/Statutes/index.cfm?Mode=Constitution&Submenu=3&Tab=statutes&CFID=182168607&CFTOKEN=22233314#A07 (accessed 20 December 2010).

- The limit does not apply to certain sources of revenues, such as revenues received from the federal government. This has meant that a lower proportion of net revenues over time have been incorporated under the revenue limitation.
- The existing limitation does not apply to local government expenditure.[46]

Recent fiscal developments have also cast doubts over the effectiveness of Florida's regime of fiscal rules which, coincidentally, is the most commonly used fiscal rule used in the US. Between 2005 and 2007 state expenditures grew by 17 per cent, on top of a twenty-year period in which per capita expenditure grew 30 per cent faster than per capita income. In 2009 Florida faced a $US5.7 billion budget deficit, which equated at 22 per cent of its General Fund, with forecasts of a deficit of $US3 billion for 2011.[47]

[46] Barry Poulson, 'Florida's Ineffective Constitutional Revenue Limit', http://www.law.fsu.edu/library/databases/ftbrc/pdf/9_20_07GPSPoulsonHandout1.pdf (accessed 20 December 2010).
[47] Matthew Mitchell, 2010, 'How to Control State Spending', The Wall Street Journal, 10 December.

Do subnational fiscal rules work? A brief summary of the empirical literature on rule design

The case studies presented above suggest that political incumbents may attempt to circumvent the effectiveness of fiscal rules, either by capitalising on pre-existing limitations (or 'loopholes') of rule design allowing for significant growth of government or weakening, through constitutional or legislative means, existing fiscal rules in place.

While there is an ongoing risk that politicians will actively attempt to weaken the binds imposed by fiscal rules, a voluminous empirical literature, particularly in the US, has shown that certain subnational fiscal rules with strong design and enforcement properties can be effective in containing the growth of state and local public sectors.

In one of the first panel data studies controlling for population and income factors affecting spending, Elder found that TELs significantly reduced the growth of US state governments.[48]

A study by James Poterba explored how US state fiscal institutions and political circumstances affect the dynamics of state taxes and spending during periods of short-term fiscal crises.[49] He found that '[s]tates that impose relatively tight constitutional or statutory rules on their legislative and executive branches, rules that make it more difficult to run fiscal deficits, experience more rapid fiscal adjustment when there are fiscal shocks.'[50]

Stansel compared state spending growth rates with TELs to the US national average, both before and after the passage of TELs.[51] It was 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 reduction in the level of per capita state expenditure in TEL jurisdictions.

Reuben addressed the issue that earlier studies critical of the impacts of TELs may have had biased results.[52] Using a model with instrumental variables to separate the impact of TELs from changes in voter preferences, it was found that spending declines by 1.8 per cent as a result of TELs.

Bails and Tieslau 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 expenditures in TEL states were $42 lower than in states without TELs.[53] In states with both TELs and balanced budget rules, spending was reduced by $135 on a per capita basis.

[48] 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.
[49] James M Poterba, 1993, 'State Responses to Fiscal Crises: The Effects of Budgetary Institutions and Politics', National Bureau of Economic Research Working Paper No. 4375.
[50] Ibid, p. 24-25.
[51] Dean Stansel, 1994, 'Taming Leviathan: Are Tax and Expenditure Limits the Answer?', Cato Institute Policy Analysis No. 213.
[52] 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.
[53] Dean Bails and Margaret Tieslau, 2000, 'The Impact of Fiscal Constitutions on State and Local Expenditures', *Cato Journal* 20 (2): 255-277.

More recent studies in the US have refined the empirical analysis by accounting for differences in TEL design. Based on this type of analysis, New found that TELs passed by voter initiative, which limit increases in revenue and spending to the sum of inflation and population growth, and that immediately return surplus funds to taxpayers tend to be more effective in reducing government spending and upholding fiscal discipline.[54]

Bae and Gais undertook an econometric analysis of the implications of TELs on state-local expenditures and revenues from 1977 to 2000. They found that 'state-level TELs significantly reduce the overall level of state and local spending (when spending is adjusted for inflation and state population). This effect is stronger when TELs are stringent and restrictive in the state and local budgetary process: for example, when they become part of the state constitution, or when they limit revenue or spending growth to slow-changing indices, such as population growth plus inflation.'[55]

In a survey of various fiscal rules and other restraints on US public sector activity, Krol found that 'TELs can slow the growth of government' and that 'TELs linked to expenditures also reduce borrowing costs on public debt' by promoting credibility in financial markets.[56]

Another survey of US state fiscal rules indicates that government expenditures grew by 8.8 per cent between 1992 and 2006 in states with a constitutional TEL, 9.8 per cent in states with a statutory TEL and 9.9 per cent in states with no TEL. In other words, a constitutional limit reduced spending growth by ten per cent compared with a statutory limit or no limitation.[57]

American economist Matthew Mitchell, based at the George Mason University Mercatus Center, has examined the size of budget gaps for US states and the existence of explanatory factors driving these outcomes.

One of these factors is the presence of a strict balanced budget requirement. After performing regression analyses, Mitchell concluded that 'when state legislators constrain themselves by adopting such a rule, they end up encountering significantly smaller budget gaps. The model estimates that those states with a strict balanced budget rule encountered budget gaps that were 8 to 10 percentage points smaller than the average.'[58]

It should be recognised that there exists a broader link between the effectiveness of fiscal rules and the economic implications of public sector size.

In a federal environment subject to limited or no tax competition, 'spending may rise to sub-optimally high levels, when sub-central policymakers face incentives to increase their spending beyond what is economically efficient due to the attenuation of the link between the

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[54] Michael J New, 2001, 'Limiting Government through Direct Democracy: The Case of State Tax and Expenditure Limitations', Cato Institute Policy Analysis no. 420.

[55] Suho Bae and Thomas Gais, 2007, 'The Effects of State-level Tax and Expenditure Limitations on Revenues and Expenditures', Rockefeller Institute Policy Brief, p. 5-6.

[56] Robert Krol, 2007, 'The Role of Fiscal and Political Institutions in Limiting the Size of State Government', *Cato Journal* 27 (3): 431-445.

[57] Daniel S Sutter and Andres Bello, 2009, 'Constitutionally Constrain Government to Unleash Capitalism', in Peter T Calcagno, Joshua C Hall and Russell S Sobel, eds., *Unleashing Capitalism: A Prescription for Economic Prosperity in South Carolina*, South Carolina Policy Council Education Foundation: Columbia.

[58] Matthew Mitchell, 2010, 'State budget gaps and state budget growth: Between a rock and a hard place', George Mason University Mercatus Center Working Paper No. 10-42.

geographical benefit of spending and burden of taxation. Alternatively, a degree of irreversibility of public spending decisions can give rise to expenditure drift, leading to an inefficiently large size of government.'[59]

Stronger fiscal rules which successfully circumscribe the growth of public sector revenue and/or expenditure promise a host of beneficial economic spinoffs. These include the possession of greater amounts of investible funds or disposable incomes by business investors and consumers respectively, and efficiency gains accrued as a result of governments possessing less revenue to expend on programs, initiatives or projects that do not provide sufficient value to the economy. Indeed, economic arguments in favour of smaller government or at least constraints on the growth of government are supported by a substantial empirical literature.[60]

It should be recognised that top-down spending rules such as those outlined in this paper are not the 'silver bullet' solution for delivering small, efficient government. As noted by economist Bryce Wilkinson, stronger fiscal rules do not necessarily 'stop governments from spending new money wastefully and funding it by cutting back on existing spending that actually offers better value for money for taxpayers at large. … A TEL should not be the sole initiative in the pursuit of value for money in government spending.'[61]

Nonetheless, it is plausible to argue that the implementation of stronger and enforceable fiscal rules should deliver a range of significant benefits to Australian taxpayers compared to the *status quo* of seemingly *ad hoc* fiscal sustainability 'wish lists' on offer by lower level governments.

[59] Douglas Sutherland, Robert Price and Isabelle Joumard, 2005, op cit, p. 144.
[60] Useful recent summaries of the empirical literature of the economic implications of public sector size may be found in: Dennis C Mueller, 2003, *Public Choice III*, Cambridge University Press, Cambridge; and Daniel Mitchell, 2005, 'The Impact of Government Spending on Economic Growth', Heritage Foundation Backgrounder No. 831.
[61] Bryce Wilkinson, 2004, *Restraining Leviathan: A Review of the Fiscal Responsibility Act 1994*, New Zealand Business Roundtable, Wellington, p. 65.

Keeping governments lean: Test-driving stronger fiscal rules for Australian states and territories

It is clear from recent experience that existing fiscal rules and associated policies, not to mention interstate and international political competition and resource mobility, have been ill-equipped to the task of ensuring fiscal discipline and restraining strong public sector growth at the state government level. Excessive recurrent spending growth has led to a failure to maintain sustainable state public finances over time in spite of the existence of policies avowedly designed to promote fiscal sustainability.

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. Such constraints to encourage governments to live within their means will become vital during this new phase of Australian economic growth and beyond.

In this paper indicative estimates of the budgetary effects of the following expenditure growth rules, based on elements of best practice in this area, are published:

- Real per capita rule: Total expenditure is capped to inflation plus population growth in each state or territory.
- Economic growth rule: Total expenditure is capped to real gross state product in each state or territory.
- Economic growth minus ‘x’ rule: Total expenditure is capped to real gross state product, minus a factor of ‘x’ determined *ex-ante* by the state government, in each state and territory. In this paper it is assumed that all states apply a factor of x equal to one.[62]

It is assumed that the rules would apply, in a broad-based fashion, to the total state public sector (comprising the general government sector, and financial and non-financial public corporations) as well as to local governments being the instrumentalities of the states.[63]

Complementing each of these rules is a strict balanced budget rule applied on an annual basis, together with *ex-post* adjustments for excess revenues or expenditures.[64]

If total revenues acquired are in excess of expenditures under each rule, the surplus revenue must be refunded to taxpayers (in an equi-proportional or other manner). Conversely, if spending under each rule exceeds total revenue then state and local policymakers would be obliged to implement additional reductions of expenditure, say, within a period of three to four

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[62] This rule is also known as the ‘Davidson-Novak rule,’ after the original proposal was set out for Tasmania in 2008. See Sinclair Davidson and Julie Novak, 2008, *Sustaining Growth: Reforms for Tasmanian Prosperity*, Paper commissioned by Tasmanian Chamber of Commerce and Industry.

[63] Data for actual revenues presented in the following section incorporate the effects of existing fiscal rules imposed by, or upon, local governments.

[64] Alternative rules that apply to the budget balance have been proposed in the literature. In the Australian context, Robert Carling and Stephen Kirchner have recently advanced a rule whereby the commonwealth budget balance should be maintained within a range of + / - two per cent of GDP. This would allow for automatic stabilisers, such as income tax receipts or unemployment benefits, to respond to changes in macroeconomic conditions. By contrast, a case for a stricter, annualised budget balance rule for state and local governments could be made on the grounds that lower levels of government in Australia possess fewer, if at all, revenue instruments and expenditure programs at their disposal that are particularly sensitive to the economic cycle.

months (and, as discussed below, may be penalised for breaches of the balanced budget rule).[65] In other words, there is no carry-over provision for budget deficits or surpluses.

The following sections provide information on the overall budgetary impact on state, and state and local, governments if the above rules were applied from 2000-01. Detailed information on impacts, on a state-by-state basis, is contained in Appendix A.

Real per capita rule (inflation plus population growth)

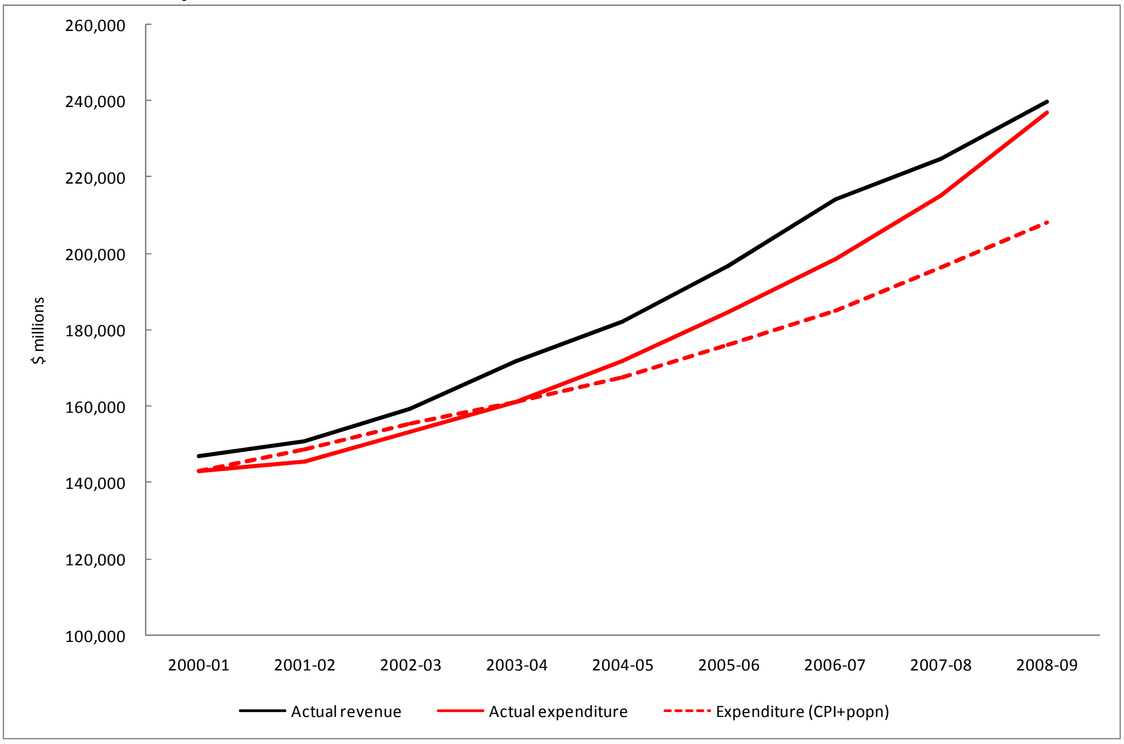
The basis for the real per capita expenditure growth rule is that spending should be permitted to grow only if government has to provide services for a larger population or if the cost of providing services increases.

Figure 5 illustrates the extent to which the pursuit of a real per capita expenditure growth rule would have constrained the growth of spending by state and local governments, particularly from 2003-04.

Expenditures under the fiscal rule would remain subject to growth, at an average annual rate of 4.8 per cent, compared to actual expenditure growth of 6.5 per cent from 2000-01 to 2008-09. The relatively slower growth in expenditures under the rule becomes more evident over the latter half of the period.

[65] It has been noted by some authors that 'a rule which covers total spending may be biased against investment, since capital spending is the more easy to change than current expenditure in the short term.' Douglas Sutherland, Robert Price and Isabelle Joumard, 2005, op cit, p. 161. However, this is not necessarily a pre-ordained outcome and various measures to promote additional fiscal consolidation would ultimately require political consent to be implemented.

Figure 5: Actual and alternative revenue and expenditure under real per capita rule, total state and local public sector



Source: ABS, Government Finance Statistics, Australia, 2008-09; IPA calculations.

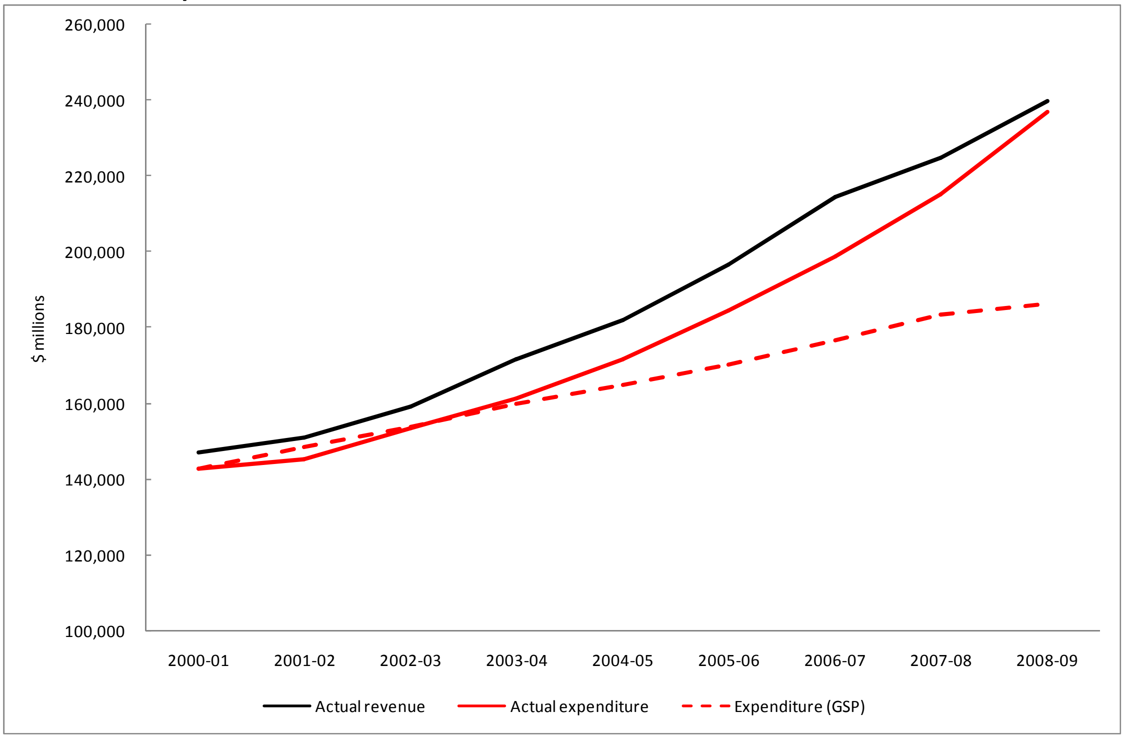
If a balanced budget rule were simultaneously enforced by the states, and their councils and shires, taxpayers would have received a substantial return on revenues acquired. From 2000-01 to 2008-09 a cumulative total of $145.5 billion in rebated revenues.

Economic growth rule (real GSP growth)

Alternatively, expenditure growth by the states and local governments could be capped to changes in real GSP in each jurisdiction. This would ensure that public sector spending does not outgrow the capacity of the economy to accommodate it.

Under this growth rule, state and local expenditures would increase at an average annual rate of 3.4 per cent from 2000-01 to 2008-09 (Figure 6). The reasonably moderate path of growth under the fiscal rule stands in sharp contrast to the rapidly increasing actual expenditure by jurisdictions for much of the past decade.

Figure 6: Actual and alternative revenue and expenditure under economic growth rule, total state and local public sector



Source: ABS, Government Finance Statistics, Australia, 2008-09; IPA calculations.

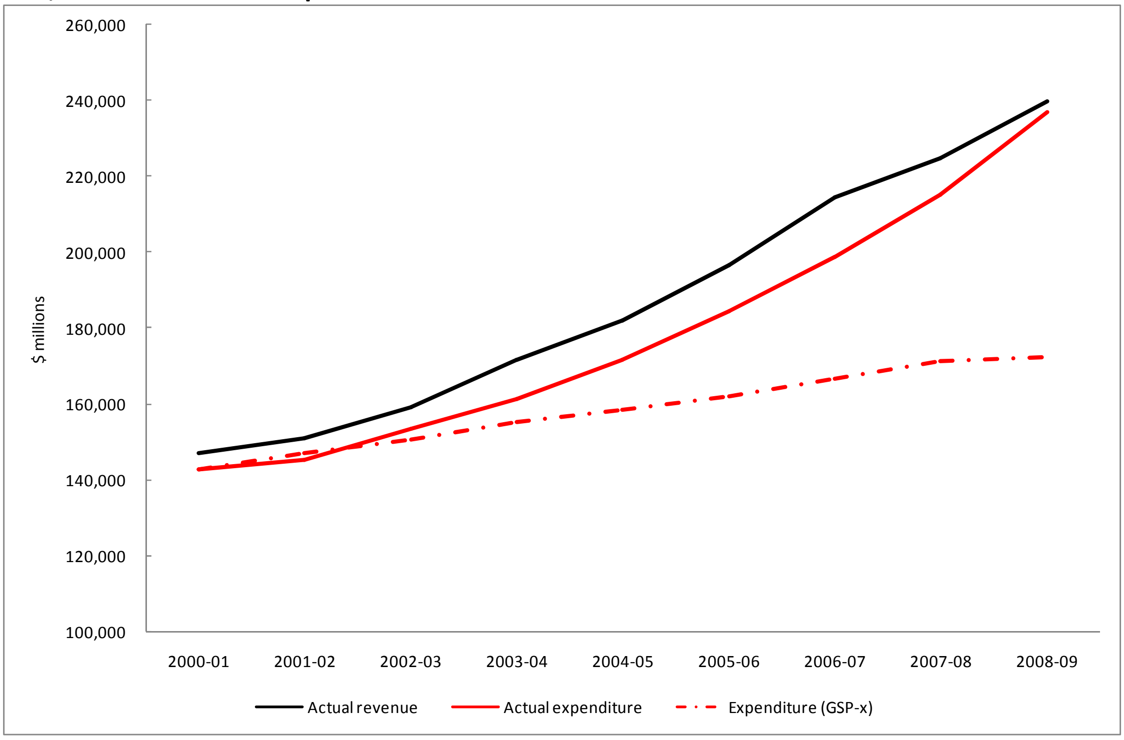
The enforcement of a balance budget rule in conjunction with the economic growth fiscal rule would imply that state and local taxpayers would receive cumulative rebates from their governments to the tune of $200 billion over the period.

Economic growth minus x rule (real GSP growth minus a factor of x)

Another proposed fiscal rule, a variation of which was originally propounded by Australian economists Sinclair Davidson and Julie Novak, would constrain the growth of state and local spending to changes in real GSP less a factor of ‘x,’ a positive integer greater than zero selected by individual state governments. Implementation and enforcement of this rule would provide additional assurances that governmental spending does not outpace the overall growth of the economy.

Assuming that all states set ‘x’ equal to one, applicable to total state and local public spending, expenditures would increase under the rule from $142.9 billion in 2000-01 to $173.3 billion in 2008-09 (Figure 7). This represents an increase in spending by state and local governments at an average annual rate of 2.4 per cent, compared to an actual 6.5 per cent increase that transpired over the period.

Figure 7: Actual and alternative revenue and expenditure under economic growth minus x rule, total state and local public sector



Source: ABS, Government Finance Statistics, Australia, 2008-09; IPA calculations.

Combined with a balanced budget rule, under which governments would be obliged to rebate taxpayers for excessive revenue raising, taxpayers across Australia would receive a cumulative return of revenues of approximately $260 billion from 2000-01 to 2008-09.

Other issues

Public sector debt rules

Australian state governments have enacted an array of legislative rules and policy guidelines with respect to the amount of net debt that may be appropriately incurred by public sector entities or rules governing the use of funds borrowed from capital markets.

The NSW *Fiscal Responsibility Act 2005* provides for a selective set of targets including:

- the level of general government sector net financial liabilities should be reduced to 7.5 per cent or less of gross state product (GSP) by 30 June 2010, and to 6 per cent or less by 30 June 2015
- underlying general government sector net debt as a proportion of GSP should be maintained at or below its 30 June 2005 level (unless an increase is required to reduce components of net financial liabilities)
- unfunded total state sector superannuation liabilities should be eliminated by 30 June 2030.

The 2010-11 Victorian Budget Papers enunciate both a short term objective of maintaining the state's AAA credit rating and a longer term goal of maintaining state government net financial liabilities ‘at prudent levels.’ In the lead up to the 2010 Victorian election, the Liberal-National Coalition opposition (now in government) put forward a framework applicable to new borrowings to finance government spending:

- infrastructure funding and other major financial commitments made by the state must be transparent to the taxpayer;
- debt should not be used to finance recurrent expenditure in the way used by the Victorian state government during the 1980s and early 1990s;
- infrastructure projects relying on debt must be individually identified in the budgetary process together with the corresponding increase in debt;
- there must be a rate of return over the life of the project which is realistic and benchmarked against other private and government infrastructure projects;
- a transparent repayment plan must exist for debt associated with infrastructure projects and programs, to be audited by the state auditor-general; and
- debt accumulated by the commonwealth government for projects normally undertaken by the states must be separately accounted for.[66]

The South Australian budget papers outline a set of medium to long term fiscal targets to be met, which also serve as performance indicators against which the government’s fiscal policies can be assessed. These include:

- a reduction in the ratio of net financial liabilities-to-revenue to that of other AAA credit rated states;
- provision of value-for-money community services and economic infrastructure within the available means;
- fully fund accruing superannuation liabilities, and fund past service superannuation liabilities;
- ensure that risks to state finances are managed prudently to maintain a AAA credit rating; and
- ensure that public non-financial corporations borrow where investments are consistent with commercial returns (including budget funding).

The ACT maintains similar fiscal strategy objectives consistent with the *Financial Management Act 1996*, including the maintenance of an AAA credit rating, the prudent management of debt and to maintain net financial liabilities within the range of all AAA-rated jurisdictions, and to fully fund the territory's unfunded superannuation liability by 2030.

Complementing rules implemented by states in relation to their management of borrowings and debt, the Australian Loan Council comprised of commonwealth and state treasurers meets annually to nominate their net financing requirements from capital markets. Whereas strict borrowing limits applied until the 1990s, the current system emphasises the need to maintain

[66] Victorian Liberal Nationals Coalition, 2010, Victorian Budget 2010 - The Legacy of John Brumby after 11 Years: Failure of Basic Services and Infrastructure, Paper by Kim Wells MP, Shadow Treasurer, http://www.kimwells.com.au/newsletters/wells-pre-budget_2010_30.04.10.pdf (accessed 9 March 2011).

public transparency toward taxpayers and financial markets as a means to ensure fiscal sustainability.

As noted above, however, strong growth has been recorded in recent years with respect to levels of net debt of the state and territory governments, and with budgetary projections revealing a continued ratcheting up in debt. This suggests that it is possible to strengthen existing rules, both limiting both the potential for governments to expend on inefficient programs that may crowd out private sector activities and the exposure of future generations of (non-consenting) taxpayers to the burden of repaying debts.

The states may impose a rule that places an upper limit upon the amount of net debt incurred by themselves and their local governments, as a percentage of GSP in their respective jurisdictions. Given the relatively narrow tax and revenue bases of the states to fund debt servicing costs, state and local governments could reasonably cap their total public sector net debt at a maximum of, say, ten per cent of GSP.[67] If a jurisdiction reaches its net debt ceiling, governments would need to pay down some of the net debt stock during a period of fiscal consolidation.[68]

Enforcement issues

Appropriate enforcement of the fiscal rules, including penalties for violation of the rules by politicians and government officials, is indispensable to minimise the prospect of political violations of fiscal rules. This, in turn, should ensure the integrity of the rule system in place and help maintain public support for measures to constrain the growth of the public sector at the state and local levels.

In recent years a number of proposals to establish Parliamentary Budget Offices or similar have been suggested to, in effect, 'depoliticise' the preparation of budget documents, including establishing the key economic and fiscal assumptions that form parameters about revenue and expenditure forward estimates.

In this paper such proposals are taken a step further. It is proposed that small statutory agencies, at arms length from government, should be established with the responsibility for monitoring and enforcing political compliance with fiscal rules established by governments.

Drawing upon the work of statistical and economic policy agencies, the agency would determine *ex-ante* the fiscal rule parameters - in other words, actual changes in GSP growth, inflation or population growth or other - that are forecast to transpire over the forward estimates period. This would enable governments to determine their own revenue and expenditure policy priorities within the fiscal rule framework for a period of three to four years ahead.

At the end of each fiscal year passed, the agency would also determine the fiscal rule parameters to have applied *ex-post* for that year. This determination would then be used by

[67] By way of a rough comparison, state non-financial public sector net debt as a proportion of GSP in 2010 ranges from between six per cent in Victoria to ten per cent in the Northern Territory.
[68] A similar proposal was made by Robert Carling and Stephen Kirchner with regards to commonwealth government net debt. Robert Carling and Stephen Kirchner, 2009, *Fiscal Rules for Limited Government: Reforming Australia's Fiscal Responsibility Legislation*, Centre for Independent Studies, Policy Monograph No. 98.

governments as the basis for any subsequent adjustments required - for example, the issuance of revenue rebate cheques or additional spending reductions - to budgets to ensure adherence to the rules.

In addition to these *ex-post* fiscal adjustments, the agency may also be charged with imposing penalties upon politicians and senior government officials for rule violations. As noted with respect to some Canadian jurisdictions, remuneration of politicians or officials could be reduced for a period of time if critical fiscal targets are not met.[69]

Consistent with the objective of fiscal rules to maintain expenditure parsimony, it is not anticipated that the establishment of such agencies would be overly expensive. In some states this could merely entail adding a new function to existing entities such as, for example, the NSW Independent Pricing and Regulatory Tribunal (IPART) or the Victorian Competition and Efficiency Commission (VCEC).

Implementation issues

In the United States there remains an active discussion concerning the relative merits of enacting state-local fiscal rules by legislation, which could be altered either at the whim of a future political majority in state houses of assembly or by inserting the details of the fiscal rules in state constitutions which can typically only be subsequently amended by a super-majority (usually two-thirds) of political representatives.

With the ability of state parliaments to amend state constitutions via a parliamentary majority, and with the scope of state constitutional referendums restricted to certain issues (such as the abolition of upper houses of parliament), debates about the desirability of legislative change versus constitutional amendment appear to have less salience in the Australian context.

That said, it is conceivable to implement legislation enacting stronger fiscal rules whereby future amendments may be approved on the basis of a super-majority vote of a parliament. This would provide additional safeguards deterring governing politicians from weakening the basis of rule coverage or application.

As discussed above, the implementation of a fiscal rule covering the state public sector should also extend to local governments and their instrumentalities. This is in recognition that local councils and shires are administrative sub-units of state governments, delegated by states to perform certain functions such as local infrastructure provision or town planning.

In addition, extensive coverage of a state fiscal rule to cover local governments would also prevent a situation whereby states pass on additional revenue or expenditure responsibilities to local governments as a means of adhering to state-only rules.

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[69] Public choice economists Dwight Lee and Richard McKenzie propose in the US federal context a ‘deficit pay schedule’ which relates the pay of members of Congress to the actual budget deficit of the preceding year. Dwight R Lee and Richard B McKenzie, 1987, *Regulating Government: A Preface to Constitutional Economics*, Lexington Books, Lexington.

Conclusion

The Australian states have actively engaged in a process of budgetary and fiscal reforms over the past two decades or so to promote public transparency of government financial operations, and in an attempt to insulate budgetary policies from the potentially damaging whims of political expediency. Some of these reforms have included:

- publication of input-output-outcome frameworks in budgets to illustrate the effect of government budgetary decisions on economic and social outcomes;
- presentation of budget documentation on the basis of accrual accounting, taking into account the long term decisions of revenue and expenditure budgetary policies;
- promotion of uniform presentation frameworks for budgetary aggregates across commonwealth, state and local governments;
- publication of budget documents prior to elections, and the submission of political party election costings to government agencies for verification;
- in a number of jurisdictions, the strengthening of parliamentary public accounts and budget oversight committees to scrutinise budgetary decisions by governments;
- establishment of independent agencies to manage government borrowing programs; and
- the introduction of legislation or policy guidelines setting medium term limits on, including the growth of, certain fiscal parameters such as taxation, expenditure and net debt.

It is argued in this paper that the introduction of stronger fiscal rules necessarily represents the necessary and, indeed, logical next step on the journey embarked upon by previous Australian governments to instill greater disciplines in the raising of revenue and subsequent expenditure of funds.

As noted by OECD researchers, other benefits are attributable to stronger fiscal rules at state and local levels of government: '[w]ell-designed rules offer the means of achieving efficiency gains from local autonomy while facilitating fiscal consolidation, providing a cushion against economic shocks and meeting the objectives of sustainable longer-term finances - challenges made more pressing by the prospective demands on sub-central government services arising from ageing populations.'[70]

Alternative stylised fiscal rules, some of which are based upon those which already exist in other countries, were applied to the budgetary profile of Australian state and local governments to test their budgetary effects compared to the actual revenue and expenditure profile recorded in recent years.

The estimates presented in this paper suggest that under stronger fiscal rule regimes, state governmental activities could be kept on a more effective 'fiscal diet' without necessarily sacrificing the delivery of core responsibilities or diluting budgetary discipline.

[70] Douglas Sutherland, Robert Price and Isabelle Joumard, 2005, op cit, p. 142.

Appendix 1.

Selected fiscal rules: State by state results

New South Wales

- Actual expenditure by state and local governments in NSW had risen by 5.4 per cent on an average annual basis between 2000-01 and 2008-09.
- If spending by both levels of government were limited to CPI plus population growth, expenditure would have increased by 4.1 per cent per annum during the same period.
- Constraining the growth of expenditures to that of NSW gross state product or gross state product minus a factor of 'x' equal to one implies that spending would have risen by 2.3 per cent or 1.3 per cent on an average annual basis respectively.

Table A.1: Actual and alternative revenue and expenditure under real per capita rule, total New South Wales state and local public sectors, $ millions

	Actual revenue	Actual expenditure	Expenditure (CPI + popn)	Expenditure (GSP)	Expenditure (GSP-x)
2000-01	49,629	46,513	46,513	46,513	46,513
2001-02	49,495	46,334	48,407	47,644	47,179
2002-03	52,145	49,637	50,143	48,994	48,044
2003-04	54,407	52,370	51,581	49,985	48,535
2004-05	56,638	54,813	53,304	50,966	49,002
2005-06	59,725	57,225	55,520	52,054	49,559
2006-07	64,148	59,722	57,869	53,508	50,447
2007-08	67,684	65,132	60,740	55,307	51,639
2008-09	72,819	70,793	64,011	55,920	51,695

Actual revenue for state and local governments incorporates the effect of 'rate pegging' constraints imposed upon NSW local governments. It is assumed that the factor of 'x' under the GSP-x rule is set at one.
Source: ABS, Government Finance Statistics, Australia, 2008-09; IPA calculations.

- The operation of a balanced budget rule in tandem with the spending growth rule suggests that taxpayers in NSW would have received a substantial rebate of excessive revenues acquired by state and local governments.
- Under a CPI plus population expenditure growth rule combined with a balanced budget restriction, taxpayers would have received a cumulative total of $38.6 billion over the period 2000-01 to 2008-09.
- If a balanced budget rule were coupled with a GSP expenditure growth rule, taxpayers would have been rebated $65.8 billion. Under balanced budgets and the GSP-x spending growth rule NSW taxpayers would have received $84.1 billion in rebated revenues.

Victoria

- Actual expenditure by state and local governments in Victoria increased by 5.9 per cent on an average annual basis between 2000-01 and 2008-09.
- If spending by both levels of government were capped at CPI plus population growth, expenditure would have increased by 4.6 per cent per annum during the same period.

- Constraining the growth of expenditures to that of Victorian gross state product or gross state product minus a factor of 'x' equal to one implies that spending would have increased by 3.1 per cent or 2.1 per cent on an average annual basis respectively.

Table A.2: Actual and alternative revenue and expenditure under real per capita rule, total Victoria state and local public sectors, $ millions

	Actual revenue	Actual expenditure	Expenditure (CPI + popn)	Expenditure (GSP)	Expenditure (GSP-x)
2000-01	32,655	31,834	31,834	31,834	31,834
2001-02	34,544	32,369	33,129	32,869	32,551
2002-03	36,277	34,550	34,629	33,988	33,333
2003-04	38,040	35,369	35,880	35,542	34,524
2004-05	39,334	37,724	37,130	36,505	35,114
2005-06	42,121	49,534	38,971	37,422	35,645
2006-07	45,632	42,764	40,773	38,752	36,556
2007-08	48,941	46,692	43,278	40,146	37,505
2008-09	51,229	50,209	45,709	40,518	37,477

It is assumed that the factor of 'x' under the GSP-x rule is set at one.
Source: ABS, Government Finance Statistics, Australia, 2008-09; IPA calculations.

- A balanced budget restriction together with a spending growth rule suggests that Victorian taxpayers would have received a substantial rebate of excessive revenues acquired by state and local governments.
- Under a CPI plus population expenditure growth rule combined with a balanced budget restriction, taxpayers would have received a cumulative total of $27.4 billion over the period 2000-01 to 2008-09.
- If a balanced budget rule were coupled with a GSP expenditure growth rule, taxpayers would have been rebated $41.2 billion. Under balanced budgets and the GSP-x spending growth rule Victorians would have received $54.2 billion in rebated revenues.

<u>Queensland</u>

- Actual expenditure by Queensland's state and local governments rose by 8.3 per cent on an average annual basis between 2000-01 and 2008-09.
- If spending by both levels of government were capped at CPI plus population growth, expenditure would have increased by 6.1 per cent per annum during the same period.
- Constraining the growth of expenditures to that of Queensland gross state product or gross state product minus a factor of 'x' equal to one implies that spending would have increased by 4.5 per cent or 3.5 per cent on an average annual basis respectively.

Table A.3: Actual and alternative revenue and expenditure under real per capita rule, total Queensland state and local public sectors, $ millions

	Actual revenue	Actual expenditure	Expenditure (CPI + popn)	Expenditure (GSP)	Expenditure (GSP-x)
2000-01	27,471	27,355	27,355	27,355	27,355
2001-02	28,650	28,895	28,749	29,017	28,744
2002-03	30,417	29,782	30,457	30,494	29,919
2003-04	35,958	31,819	32,146	32,384	31,475
2004-05	39,590	34,505	33,803	33,997	32,727
2005-06	43,346	38,105	35,812	35,410	33,761
2006-07	49,120	44,739	38,051	37,319	35,242
2007-08	47,224	46,959	40,952	38,896	36,380
2008-09	50,605	51,708	43,988	38,991	36,104

It is assumed that the factor of 'x' under the GSP-x rule is set at one.
Source: ABS, Government Finance Statistics, Australia, 2008-09; IPA calculations.

- A balanced budget restriction combined with a spending growth rule suggests that taxpayers in Queensland would have received a substantial rebate of excessive revenues acquired by state and local governments.
- Under a CPI plus population expenditure growth rule combined with a balanced budget restriction, Queenslanders would have received a cumulative total of $41.1 billion over the period 2000-01 to 2008-09.
- If a balanced budget rule were coupled with a GSP expenditure growth rule, taxpayers would have been rebated $48.5 billion. Under balanced budgets and the GSP-x spending growth rule Queensland taxpayers would have received $60.7 billion in rebated revenues.

Western Australia

- Actual expenditure by state and local governments in WA rose by 8.1 per cent on an average annual basis between 2000-01 and 2008-09.
- If spending by both levels of government were restricted to CPI plus population growth, expenditure would have increased by 5.6 per cent per annum during the same period.
- Constraining the growth of expenditures to that of WA gross state product or gross state product minus a factor of 'x' equal to one implies that spending would have increased by 4.9 per cent or 3.9 per cent on an average annual basis respectively.

Table A.4: Actual and alternative revenue and expenditure under real per capita rule, total Western Australia state and local public sectors, $ millions

	Actual revenue	Actual expenditure	Expenditure (CPI + popn)	Expenditure (GSP)	Expenditure (GSP-x)
2000-01	16,924	16,529	16,529	16,529	16,529
2001-02	17,315	16,789	17,201	17,658	17,492
2002-03	18,245	17,729	17,904	18,325	17,979
2003-04	19,703	18,392	18,572	19,446	18,898
2004-05	21,569	19,677	19,506	20,280	19,520
2005-06	24,908	21,868	20,808	21,426	20,428
2006-07	26,801	23,673	22,266	22,364	21,118
2007-08	29,203	26,324	23,850	23,299	21,790
2008-09	31,546	30,841	25,548	24,264	22,474

It is assumed that the factor of 'x' under the GSP-x rule is set at one.
Source: ABS, Government Finance Statistics, Australia, 2008-09; IPA calculations.

- A balanced budget restriction in conjunction with a spending growth rule suggests that WA taxpayers would have received a substantial rebate of excessive revenues acquired by state and local governments.
- Under a CPI plus population expenditure growth rule combined with a balanced budget restriction, Western Australians would have received a cumulative total of $24 billion over the period 2000-01 to 2008-09.
- If a balanced budget rule operated with a GSP expenditure growth rule, WA taxpayers would have been rebated $22.6 billion. Under balanced budgets and the GSP-x spending growth rule taxpayers would have received $30 billion in rebated revenues.

South Australia

- Actual expenditure by South Australian state and local governments increased by 5.9 per cent on an average annual basis between 2000-01 and 2008-09.
- If spending by both levels of government were limited to CPI plus population growth, expenditure would have increased by 4.2 per cent per annum during the same period.
- Constraining the growth of expenditures to that of South Australian gross state product or gross state product minus a factor of 'x' equal to one implies that spending would have risen by 2.9 per cent or 1.9 per cent on an average annual basis respectively.

Table A.5: Actual and alternative revenue and expenditure under real per capita rule, total South Australia state and local public sectors, $ millions

	Actual revenue	Actual expenditure	Expenditure (CPI + popn)	Expenditure (GSP)	Expenditure (GSP-x)
2000-01	10,917	11,142	11,142	11,142	11,142
2001-02	11,341	11,526	11,517	11,597	11,486
2002-03	12,041	11,840	12,063	11,800	11,571
2003-04	12,980	12,474	12,526	12,297	11,944
2004-05	13,738	13,552	12,938	12,419	11,942
2005-06	14,080	14,053	13,510	12,760	12,151
2006-07	15,004	14,578	14,078	13,025	12,282
2007-08	16,602	15,797	14,783	13,759	12,851
2008-09	17,478	17,666	15,544	14,044	12,989

It is assumed that the factor of 'x' under the GSP-x rule is set at one.
Source: ABS, Government Finance Statistics, Australia, 2008-09; IPA calculations.

- A balanced budget restriction combined with a spending growth rule suggests that taxpayers would have received a substantial rebate of excessive revenues acquired by South Australia's state and local governments.
- Under a CPI plus population expenditure growth rule combined with a balanced budget restriction, taxpayers would have received a cumulative total of $6.1 billion over the period 2000-01 to 2008-09.
- If a balanced budget rule were combined with a GSP expenditure growth rule, South Australian taxpayers would have been rebated $11.3 billion. Under balanced budgets and the GSP-x spending growth rule taxpayers would have received $15.8 billion in rebated revenues.

Tasmania

- Actual expenditure by state and local governments in Tasmania increased by 7.3 per cent on an average annual basis between 2000-01 and 2008-09.
- If spending by both levels of Tasmanian government were capped at CPI plus population growth, expenditure would have increased by 3.9 per cent per annum during the same period.
- Constraining the growth of expenditures to that of gross state product or gross state product minus a factor of 'x' equal to one implies that spending would have increased by 3.5 per cent or 2.5 per cent on an average annual basis respectively.

Table A.6: Actual and alternative revenue and expenditure under real per capita rule, total Tasmania state and local public sectors, $ millions

	Actual revenue	Actual expenditure	Expenditure (CPI + popn)	Expenditure (GSP)	Expenditure (GSP-x)
2000-01	4,140	4,030	4,030	4,030	4,030
2001-02	4,380	4,178	4,122	4,235	4,195
2002-03	4,599	4,384	4,286	4,368	4,285
2003-04	4,921	4,689	4,448	4,556	4,426
2004-05	5,283	5,035	4,639	4,659	4,482
2005-06	6,001	5,911	4,837	4,783	4,556
2006-07	6,255	6,138	5,010	4,904	4,626
2007-08	6,791	6,531	5,232	5,119	4,782
2008-09	7,209	7,090	5,466	5,292	4,896

It is assumed that the factor of 'x' under the GSP-x rule is set at one.
Source: ABS, Government Finance Statistics, Australia, 2008-09; IPA calculations.

- The operation of a balanced budget rule in tandem with the spending growth rule suggests that Tasmanian residents would have received a substantial rebate of excessive revenues acquired by state and local governments.
- Under a CPI plus population expenditure growth rule in conjunction with a balanced budget restriction, residents would have received a cumulative total of $7.5 billion over the period 2000-01 to 2008-09.
- If a balanced budget rule were coupled with a GSP expenditure growth rule, residents in Tasmania would have been rebated $7.6 billion. Under balanced budgets and the GSP-x spending growth rule residents would have received $9.3 billion in rebated revenues.

Australian Capital Territory

- The ACT is the only state or territory in Australia to deliver both state and local services through one level of government.
- Actual expenditure in the ACT had risen by 5.2 per cent on an average annual basis between 2000-01 and 2008-09.
- If spending were capped at CPI plus population growth, expenditure would have increased by 4.6 per cent per annum during the same period.
- Constraining the growth of expenditures to that of ACT gross state product or gross state product minus a factor of 'x' equal to one implies that spending would have risen by 2.9 per cent or 1.9 per cent on an average annual basis respectively.

Table A.7: Actual and alternative revenue and expenditure under real per capita rule, total Australian Capital Territory state and local public sectors, $ millions

	Actual revenue	Actual expenditure	Expenditure (CPI + popn)	Expenditure (GSP)	Expenditure (GSP-x)
2000-01	2,390	2,475	2,475	2,475	2,475
2001-02	2,218	2,277	2,568	2,545	2,520
2002-03	2,487	2,401	2,679	2,639	2,588
2003-04	2,529	2,763	2,770	2,649	2,572
2004-05	2,519	2,917	2,860	2,727	2,622
2005-06	2,744	3,078	3,007	2,828	2,693
2006-07	3,098	3,032	3,158	2,976	2,807
2007-08	3,578	3,379	3,346	3,072	2,869
2008-09	3,667	3,720	3,548	3,112	2,878

It is assumed that the factor of 'x' under the GSP-x rule is set at one.
Source: ABS, Government Finance Statistics, Australia, 2008-09; IPA calculations.

- Under a system in which the GSP and GSP-x rules were combined with a balanced budget requirement, residents in the ACT would have received a cumulative total of $208 million and $1.2 billion respectively over the period 2000-01 to 2008-09.
- However, a balanced budget rule in tandem with a CPI plus population growth rule would have implied, for most years, an excess of spending over revenue.
- Under the fiscal rule regimes suggested in this paper, this would imply that the ACT government would have been required to find additional *ex-post* expenditure savings from its budget (with the possibility of financial penalties also applied to territory politicians and senior departmental officials for breaches of the fiscal rules).
- In 2007-08 and 2008-09 ACT residents would have received revenue rebates of $232 million and $119 million respectively when a CPI+population spending growth rule operates in tandem with balanced budgets.

Northern Territory

- Actual expenditure by state and local governments in the NT rose by 6.4 per cent on an average annual basis between 2000-01 and 2008-09.
- If spending by both levels of government were capped at CPI plus population growth, expenditure would have increased by 4.7 per cent per annum during the same period.
- Constraining the growth of expenditures to that of NT gross state product or gross state product minus a factor of 'x' equal to one implies that spending would have increased by 3.8 per cent or 2.8 per cent on an average annual basis respectively.

Table A.8: Actual and alternative revenue and expenditure under real per capita rule, total Northern Territory state and local public sectors, $ millions

	Actual revenue	Actual expenditure	Expenditure (CPI + popn)	Expenditure (GSP)	Expenditure (GSP-x)
2000-01	2,892	3,028	3,028	3,028	3,028
2001-02	3,009	3,025	3,124	3,074	3,044
2002-03	3,073	3,137	3,209	3,104	3,043
2003-04	3,290	3,358	3,282	3,170	3,077
2004-05	3,477	3,527	3,416	3,343	3,215
2005-06	3,897	3,809	3,613	3,569	3,399
2006-07	4,279	4,018	3,860	3,726	3,515
2007-08	4,902	4,378	4,110	3,889	3,634
2008-09	5,187	4,973	4,385	4,089	3,784

It is assumed that the factor of 'x' under the GSP-x rule is set at one.
Source: ABS, Government Finance Statistics, Australia, 2008-09; IPA calculations.

- The operation of a balanced budget rule in tandem with the spending growth rule suggests that NT residents would have received a substantial rebate of excessive revenues acquired by state and local governments.
- Under a CPI plus population expenditure growth rule together with a balanced budget restriction, territory residents would have received a cumulative total of $2 billion over the period 2000-01 to 2008-09.
- If a balanced budget rule were coupled with a GSP expenditure growth rule, residents in the NT would have been rebated $3 billion. Under balanced budgets and the GSP-x spending growth rule residents would have received $4.3 billion in rebated revenues.