

Chapter 4

Financial Management

4.1 This chapter builds on information contained in chapter 3 to analyse state and territory financial management. It discusses interest payments, public sector wages, unfunded superannuation liabilities, and financial forecasting as key features of financial management across the states. The chapter then examines the main revenue sources of state government; taxation, and income from the Commonwealth. Finally, the chapter touches on the financial relationship between state and local levels of government. However, the first, and perhaps most significant aspect of financial management in this chapter, is debt levels and management.

Debt

4.2 Of itself, debt is not symptomatic of a problem for sustainable budgeting. It is common practice for governments to borrow even when they have a cash surplus. For example, the Australian Government is committed to issuing sufficient Treasury Bonds to support the Treasury Bond Futures market, despite having large cash surpluses to fund spending.¹

4.3 Infrastructure management, which is dealt with substantively in chapter 6, is a case in point. Borrowing to fund economically responsible infrastructure spending does not necessarily reflect poor economic management. In fact, it can help to spread the financial burden of paying for that infrastructure across those generations that benefit from it. Infrastructure can expand the nation's productive capacity thereby allowing it to achieve strong, sustainable growth with low inflation.² However it may be that it is inefficient for governments to borrow to build infrastructure if the private sector could have built that infrastructure instead. Governments have been loath to borrow in recent decades. It is commonly held that incurring debt, for whatever purpose, is deeply unpalatable to voters in contemporary Australia. Mr Henry Ergas provided the committee with his analysis of the situation as it affects state and territory governments:

What is true is that in the late nineties we were coming out of the situation during the eighties and early nineties where state governments had in numerous instances managed their fiscal positions extremely poorly. Because they had managed their fiscal positions extremely poorly, there was an overhang of debt and widespread concern among the public that further accumulation of debt or further spending by state governments might well be as inefficient as some of the spending that had occurred in previous years had proven to be.

1 Department of the Treasury, *Submission 25*, p. 5.

2 Department of the Treasury, *Submission 25*, p. 5.

In my view, what happened at that point was that we got both the wrong prescription and the wrong implementation of the prescription. We got the wrong prescription in the sense that the conclusion was drawn that what state governments should do was look like the Commonwealth and essentially have either a cyclically adjusted budget surplus or aim to run surpluses over the course of the economic cycle, if not over an even shorter time frame than that. That is a position that makes sense from the point of view of the Commonwealth, but in our system of government it is not the right fiscal rule for state governments, given that those state governments have responsibility for providing some very long-lived assets.

...

Additionally, we got the wrong implementation of that prescription, because there were many areas where state governments could have and should have improved the quality of their outlays, including infrastructure. The right way to do it would have been to focus on improving the quality of state government spending—looking at areas such as public services, where there was doubtless potential to improve efficiency significantly—making savings to the extent to which they could be made without compromising service delivery to the public and continuing to fund vital infrastructure. Instead, what we got, and what emerges quite clearly when you look at the state government finances over the period, were severe constraints imposed on funding for the long term and much less severe constraints imposed on funding that had much more short-term objectives and were much more visible in the short term. That is understandable; that is the nature of the world in which governments operate, but it meant that we then entered a period of very strong economic growth with key players in our system in infrastructure delivery not having done their bit. That was not the sole factor but it contributed to the difficulties that we had subsequently.³

4.4 Representatives from a number of state opposition parties gave evidence in relation to debt, often expressing misgivings about its escalation in their state in recent years.⁴ Views expressed by Dr Bruce Flegg MP, the Queensland Shadow Treasurer were typical. Dr Flegg said that:

...the issue of government debt is particularly concerning. In the past two state budgets, we have seen a dramatic escalation of borrowings that are now forecast to reach over \$64 billion by 2011–12. Most of this debt is [GBE] sector debt, with Queensland's [GBE] sector having the highest gearing ratio of any state, at around 70 per cent.

...

3 Mr Henry Ergas, personal capacity, *Committee Hansard*, 25 July 2008, pp 44–45.

4 See, for example, Mr Kim Wells, Shadow Treasurer for Victoria, *Submission 3*, p. 3.

...this government has left Queensland's budget enormously vulnerable—and I think 'vulnerable' is probably the appropriate word to describe it—particularly as we enter a period of economic uncertainty.⁵

4.5 The level of debt held by states attracted significant comment from other witnesses. The Australian Industry Group (AiG) commented that:

It is our belief that the borrowing and debt positions of the Australian states and Territories have been overly conservative for some time. This has been associated with a significant underinvestment in Australia's infrastructure. In recent years...this overly-conservative stance has been wound back and the states and territories have become more willing to borrow and to make inroads into the backlog of important projects that has built up over many years.

...

It is difficult to rationalise the excessive focus on reducing debt. It has little basis in good economic management but seems rather to be driven by an ideological position.⁶

4.6 Officials from the Treasury submitted that, by historical standards, the projected level of debt for states in the forward years is relatively low.⁷

4.7 Putting aside the borrowings themselves, the timing of investment in recent years also bears directly upon the states' management of their finances. On this point, Mr Henry Ergas observed that:

I believe that what has happened is that the states, which should have been investing in expanding productive capacity throughout the late 1990s and the early part of this century, stalled that investment. That created bottlenecks and constraints, and those bottlenecks and constraints added to the extent of the constraints in the economy as a whole. When those constraints became both severe and apparent, the states then largely reversed course and at that point greatly expanded their infrastructure spending—just at a time when the private sector was also expanding very heavily. If the states had followed a more steady-as-she-goes course then we would have had less competition for resources in the period subsequent to 2005. But they did not. As regards the period from 2005, the problem there is that we have had both this accentuated competition for resources and, within that, many projects which look like they are relatively poor quality or where it is very difficult to assess the quality of those projects. What those projects are doing is displacing private sector investment, which

5 Dr Bruce Flegg, Shadow Treasurer for Queensland, *Committee Hansard*, 17 July 2008, pp 1–2.

6 Australian Industry Group, *Submission 21*, p. 1.

7 Mr Tony McDonald, General Manager, Department of the Treasury, *Committee Hansard*, 25 July 2008, p. 74.

is being truly market tested. We know that that private sector investment will in the long run yield real benefits to the community.⁸

4.8 Again, this evidence is expanded on in chapter 6, but the implication is that state investment was ill-timed. It occurred at a time when the private sector was also seeking resources for its own projects. It is uncontroversial to say that this increase in demand boosted the price of the project inputs, especially skilled labour, and that the final price paid by taxpayers, through their governments, was higher than it might otherwise have been. Mr Ergas also warned:

...but even worse to have that stop-go cycle coincide with overall cyclical movements in the economy, which means that you, as it were, open the tap to the full just as the economy is going into what looks like a period of overheating or at least where labour markets and product markets are very tight. Hence, you accentuate all of the inflationary pressures underway in the economy. That in my view highlights a serious failure of policy.⁹

4.9 The committee shares the concerns of Mr Ergas that badly planned and badly managed infrastructure investment, and in the past few years, has put upward pressure on inflation.

4.10 To address the issue of 'whether the combined spending envelope of both Commonwealth and the States can be delivered in prevailing economic conditions without putting at risk the Government's inflation targets',¹⁰ there does need to be some overall mechanism to ensure that governments' borrowings and spendings do not negate the Federal Government's economic goals.

4.11 Mr Swan in his Press release, mentions the Australian Loan Council. The committee considers that it may be appropriate to re-energise the Australian Loan Council.

Overview of the Australian Loan Council

4.12 The Loan Council's origins lie in the 1920s when the Commonwealth and States competed for funds on capital markets. Whilst the Commonwealth wanted to refinance war debt, the States were interested to fund infrastructure programs. To resolve this and other disputes, the May 1923 Premiers' Conference agreed to form a

8 Mr Henry Ergas, personal capacity, *Committee Hansard*, 25 July 2008, p. 43.

9 Mr Henry Ergas, personal capacity, *Committee Hansard*, 25 July 2008, p. 38.

10 The Hon Wayne Swan, MP, Treasurer of the Commonwealth of Australia, 'Investing In a Modern Federation', Press release 037, 13 May 2008, www.treasurer.gov.au/DisplayDocs.aspx?doc=pressreleases/2008/037.htm&pageID=003&min=wms&Year=&DocType=0 (accessed 4 September 2008).

voluntary Loan Council responsible to coordinate the timing of debt issues and deal with other matters including interest rates on issues of securities.¹¹

4.13 The Loan Council formally came into being in 1927 and the ratified Financial Agreement was incorporated into the *Financial Agreement Act 1928* (the Act). Amongst other things, the Act provided for:

- the Loan Council to regulate borrowing by the Commonwealth and States;
- the Commonwealth to borrow on the States' behalf;
- limits on the States' borrowing powers;
- the Commonwealth and the States to contribute to the National Debt Sinking Fund to redeem debt; and
- the Commonwealth to provide grants to the States to help them meet interest payments and Sinking Fund contributions.¹²

4.14 In the 1950s, a major change to the role of the Loan Council took place given that the Commonwealth increasingly viewed it as an instrument of macroeconomic policy. The Commonwealth Treasurer advocated a reduction of Council-approved borrowing to ease strong inflationary pressures. The Commonwealth's influence over the Loan Council was strengthened given that the Commonwealth undertook to provide funds to the States if the States were unable to raise, through the issue of securities, any borrowing that the Loan Council had approved. In effect, 'the Commonwealth agreed to underwrite State borrowing'.¹³

4.15 Mr Geoffrey Anderson appearing before the committee in a private capacity made note of the role of the Loan Council in the 1970s and 1980s:

The deregulation of world financial markets in the mid-1970s to the 1980s and the pressure on state governments to borrow money to fund an early infrastructure boom, coupled with the rapid deregulation of the Australian financial system following the floating of the dollar in 1983, put great strain on the agreements which had governed the level of borrowing by both the Commonwealth on behalf of the states, through the Loan Council, and borrowing by the states' own authorities. All this was happening at a time when the Commonwealth was attempting to significantly reduce the overall public sector borrowing requirement. I should add there is an interesting academic debate about whether that was a good idea but the fact is that at that time there was enormous pressure from the Hawke and Keating governments to reduce government borrowing.

11 Mr Richard Webb, *The Australian Loan Council*, Parliamentary Library Research Note no 43, 2001–02, 18 June 2002, p.1.

12 Mr Richard Webb, *The Australian Loan Council*, Parliamentary Library Research Note no 43, 2001–02, 18 June 2002, p. 1.

13 Mr Richard Webb, *The Australian Loan Council*, Parliamentary Library Research Note no 43, 2001–02, 18 June 2002, p. 2.

It is fair to say that most of those arrangements were failing, particularly the so-called global limits where the states agreed to limit their borrowings to a global limit. States were borrowing and conducting transactions which effectively amounted to borrowing outside of the Loan Council. Slowly, by the mid-1990s those agreements had been replaced by a system in which the states were responsible for their total borrowing within financial markets, which was specifically designed to increase the market scrutiny on the fiscal and debt management of the individual states.¹⁴

4.16 In response to such trends which undermined the Loan Council's effectiveness, new arrangements were adopted for monitoring and reporting in the early 1990s. These arrangements provided for each jurisdiction to nominate a Loan Council Allocation, based on its net borrowing as indicated by its deficit/surplus.¹⁵ Of the agreement, Mr Anderson explains:

The 1992 meeting of the Loan Council also agreed to amend the Financial Agreement to permit the states to issue securities in their own name in both domestic and overseas markets and to remove the requirement that borrowings needed to be approved under the provisions of that agreement.

Taken together, these changes completed the process which had been underway for more than a decade, of moving the control of government borrowing back into the market, and this establishing a new relationship between the public sector and the markets. As the Commonwealth budget papers described the process: "The changes in Loan Council arrangements broadly reflect the evolving nature of financial markets and their interaction with the public sector. The new arrangements are designed to enhance the role of financial market scrutiny as a discipline on the public sector and, in doing so, build on the changes instituted in the 1980s to enable the individual states to assume responsibility for managing their own borrowings and to be accountable to financial markets for their actions".¹⁶

4.17 The impact of these changes was that borrowing by the individual States was now much more subject to financial market scrutiny, a mechanism designed to impose the financial discipline upon them which previously had been the province of the Loan Council.¹⁷

4.18 As of 1 July 1995, the Loan Council operated under the *Financial Agreement between the Commonwealth, States and Territories* which is incorporated as a

14 Mr Geoffrey Anderson, private capacity, *Committee Hansard*, 27 March 2008, pp 52–53.

15 Mr Richard Webb, *The Australian Loan Council*, Parliamentary Library Research Note no 43, 2001–02, 18 June 2002, p. 2.

16 Mr Geoffrey Anderson, *Submission 19*, Attachment C, p. 9. The Commonwealth Budget Paper referred to is Budget Paper No 4: Commonwealth Financial Relations with other Levels of Government 1993–1994 PP90 of 1993. p. 65.

17 *Loan Council mid-1990s*, Client Memorandum, Richard Webb, Parliamentary Library, 4 September 2008.

schedule to the *Financial Agreement Act 1994*. The Financial Agreement incorporates changes agreed in 1992 which:

- remove the requirement for Commonwealth and State borrowings to be approved under the Agreement;
- remove the Commonwealth's explicit power to borrow on the States' behalf;
- abolishes the restriction on State's borrowing through the issue of securities in their own name; and
- includes the Australian Capital Territory and Northern Territory as members.¹⁸

4.19 Mr Anderson explains the ramifications of these changes:

As a consequence the borrowing arrangements of the Federation had become as “deregulated” as the nation’s financial system had during the 1980s, with the States active players in domestic and global financial markets. But while borrowing arrangements were deregulated they were not “unregulated”. Rather than being governed by constitutional provision, legislative scheme or political agreement they were now being regulated by the financial markets and in particular by an agent of the markets in the form of international credit ratings agencies.¹⁹

The contemporary role of the Australian Loan Council

4.20 The Loan Council which is formally a Commonwealth-State Ministerial council comprising Commonwealth, state and territory treasurers meets once a year to consider the nominations having regard to each jurisdiction's fiscal position.

4.21 Of the current status of the Loan Council, Mr Anderson stated:

In recent years, the pressure to renew infrastructure and provide new infrastructure for economic development has seen the pressure for zero debt or near zero debt to modify. Increasingly, the rating agencies have been at pains to point out that they do not necessarily follow an approach of no debt whatsoever. I think we saw that in New South Wales and Victoria last year, when both states announced major capital programs and the rating agencies came out broadly in support of that capital expenditure. They made the point in both cases that their overall financial position could support greater borrowings. Of course, the Loan Council has not totally vacated the field: states have to agree among themselves at the Loan Council for their allocation of the amount they are going to borrow, which is a methodology that now takes account of transactions that are not strictly debt but nevertheless have implications for the amount of risk states take on. In

18 Mr Richard Webb, *The Australian Loan Council*, Parliamentary Library Research Note no 43, 2001–02, 18 June 2002, p. 2.

19 Mr Geoffrey Anderson, *Submission 19*, Attachment C, p. 2.

short, they look at the overall financial requirements of the states rather than their formal borrowing.²⁰

4.22 The role of the Loan Council is now primarily that of monitoring and approving the loan programs of the Commonwealth and the States. Since the new financial agreement in 1995 between Federal and State governments, the Loan Council's borrowing constraints have essentially been voluntary. Indeed, it has been 15 years since the Loan Council has amended any borrowing proposals of the States.²¹

4.23 Nevertheless, the current Loan Council arrangements are still used as a tool of macroeconomic policy. The overall level of conventional borrowings and other financing arrangements proposed by the Commonwealth and the States is still assessed for consistency with Commonwealth macroeconomic objectives.

4.24 In relation to a possible alarm trigger mechanism in relation to state debt levels, Mr Derek Bazen, an Analyst at the Department of the Treasury informed the committee:

...whilst the role of the Australian Loan Council has changed, the Australian Loan Council do still meet following the Ministerial Council on Federal Financial Relations, and they consider the aggregate borrowing requirements of all Australian governments. I would anticipate that, should there be borrowings at levels that are ringing those sorts of alarms, that would be the forum at which those issues would be raised and dealt with.²²

4.25 Given the scope for the Australian Loan Council to provide a greater oversight of state borrowing, the committee makes a recommendation (Recommendation 10) in chapter 8 to investigate mechanisms to enhance and strengthen the powers of the Australian Loan Council to scrutinise excessive growth in state debt.

Interest

4.26 The costs of borrowing have escalated along with the level of state debt in recent years. An estimate of state interest payments as a percentage of Gross State Product (GSP)/GDP for the General Government Sector, the Public Non-financial Corporations sector and the Non-financial Public sector, each show an upward trend of the level of state borrowing over the forward estimates as states fund their infrastructure programs. However, these payments remain a small percentage of the states' GSP.²³ A year on year breakdown for the period 2000–01 to 2010–11, compiled from state data, is presented in Tables 4.1, 4.2 and 4.3 below.

20 Mr Geoffrey Anderson, private capacity, *Committee Hansard*, 27 March 2008, p. 54.

21 See as an example, Budget Paper No. 3: *Australia's Federal Relations 2008–09*, p. 85.

22 Mr Derek Bazen, Analyst, State Finances Unit, Commonwealth State Relations, Department of the Treasury, *Committee Hansard*, 25 July 2008, p. 82.

23 Department of the Treasury, *Submission 25*, p. 7.

Table 4.1—General government sector borrowing as a percentage of GSP/GDP, 2000–01 to 2010–11

	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11
NSW	5.06	4.31	3.81	3.79	3.79	3.82	3.79	3.88	4.20	4.41	4.59
Vic	3.57	3.36	3.12	2.56	2.45	2.61	2.91	2.54	3.12	3.61	3.99
Qld	2.28	2.37	2.43	1.87	1.69	1.17	1.16	2.66	3.83	5.48	6.91
WA	2.96	2.60	2.43	1.95	1.28	0.85	0.70	0.83	0.68	0.55	0.51
SA	6.45	6.36	5.31	4.47	3.68	3.39	3.44	2.97	3.57	4.23	4.89
Tas	11.76	11.23	5.19	3.66	2.19	0.83	0.64	1.46	1.30	1.22	1.15
ACT	4.54	4.14	3.78	3.56	3.54	3.50	3.19	3.54	4.51	4.25	4.00
NT	18.08	19.16	17.76	16.03	14.39	13.02	12.04	11.02	10.23	9.76	9.31
States	4.35	3.99	3.53	3.11	2.87	2.68	2.69	2.89	3.37	3.90	4.36

Source: Commonwealth Treasury, *Supplementary Submission*, p. 5.

4.27 The level of borrowing for the state PNFC sector is perhaps more relevant, because this sector owns nearly all of the stock of state public debt (see Table 4.2 below).

Table 4.2—Public non-financial corporations borrowing as a percentage of GSP/GDP, 2000–01 to 2010–11

	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11
NSW	4.76	4.59	4.52	4.42	4.55	4.87	5.71	5.63	6.51	7.31	8.06
Vic	1.42	1.29	1.47	1.67	1.72	1.96	1.96	2.26	3.28	4.25	4.68
Qld	9.89	9.90	10.20	8.31	8.16	8.90	11.29	11.67	14.32	15.39	16.16
WA	7.33	7.00	7.09	7.36	7.52	7.51	6.11	6.90	8.23	8.75	8.73
SA	2.58	2.39	2.38	2.33	2.24	2.11	2.18	2.37	2.53	3.02	3.75
Tas	11.55	12.94	11.60	11.34	11.56	10.24	9.41	9.18	9.26	9.59	9.70
ACT	0.03	0.01	0.01	0.02	0.01	0.01	0.00	0.00	0.02	0.04	0.06
NT	7.02	3.81	3.96	3.53	2.95	2.92	2.68	3.00	3.53	3.86	4.37
States	4.93	4.80	4.86	4.60	4.68	5.02	5.60	5.86	7.09	7.96	8.56

Source: Commonwealth Treasury, *Supplementary Submission*, p. 6.

4.28 Combining the borrowings of these two sectors of government yields the Non-financial Public Sector figures, which represent the overall presented in Table 4.3.

Table 4.3—Non-financial public sector borrowing as a percentage of GSP/GDP, 2000–01 to 2010–11

	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11
NSW	9.82	8.90	8.33	8.21	8.34	8.68	9.48	9.47	10.65	11.65	12.56
Vic	4.99	4.65	4.59	4.23	4.17	4.57	4.86	4.80	6.21	7.66	8.47
Qld	12.08	12.21	12.56	10.17	9.84	10.04	12.27	14.32	18.15	20.87	23.06
WA	10.28	9.60	9.52	9.31	8.80	8.35	6.82	7.72	8.91	9.30	9.24
SA	9.03	8.76	7.68	6.80	5.91	5.50	5.62	5.35	6.10	7.25	8.64
Tas	23.30	24.16	16.80	14.96	13.75	11.08	10.05	10.64	10.56	10.81	10.85
ACT	4.57	4.15	3.79	3.58	3.55	3.51	3.19	3.54	4.52	4.28	4.06
NT	25.10	22.97	21.73	19.56	17.35	15.94	14.72	14.01	13.76	13.62	13.68
States	9.27	8.77	8.38	7.71	7.55	7.69	8.24	8.74	10.40	11.78	12.85

Source: Commonwealth Treasury, *Supplementary Submission*, p. 7.

Public sector wages

4.29 The committee notes the disparity between the Commonwealth and state governments on public sector wages. For example during the June quarter 2007 the Commonwealth spent \$3.8 billion compared to \$17.8 billion in spending by the states.²⁴

4.30 During the course of its hearings, the committee heard significant evidence on the growth in state government spending on their public service. Mr Henry Ergas submitted that the 'poor performance' of state and territory governments in part reflected a failure to contain public sector wage costs.²⁵ During the period September 1997 to March 2008, increases in the Labour Price Index (LPI)²⁶ for the public sector in many states and territories substantially exceeded those for the private sector. Over the same period, the LPI for the Commonwealth public sector closely tracked that of the private sector as a whole. Most noteworthy among the states was New South Wales where government wage growth exceeded that in the private sector by over 14 percentage points. Table 4.4 sets out the relative levels of wages growth between public and private sectors over time.

Table 4.4—Growth in Labour Price Index, September 1997 to March 2008

Jurisdiction	Public Sector (per cent increase)	Private Sector (per cent increase)
NSW	56.8	42.3
Victoria	43.1	43.0
Queensland	49.7	43.3
SA	52.0	43.0
WA	44.1	49.4
Tasmania	47.3	39.7
ACT	49.4	42.6
NT	43.9	40.4
Commonwealth	45.6	43.3

Source: Mr Henry Ergas, *Submission 42*, p. 6. Drawn from ABS, decomposing data published in ABS Cat 6345.0 Labour Price Index.

4.31 The committee acknowledges the warning it received from Dr Tony Richards, representing the Reserve Bank of Australia, in relation to the LPI:

24 Australian Bureau of Statistics, *Wage and Salary Earners, Public Sector, Australia*, June 2007. www.abs.gov.au/AUSSTATS/abs@.nsf/ProductsbyCatalogue/C976CA0DFCB18A1BCA25707C007B02D4?OpenDocument (accessed 5 September 2008).

25 Mr Henry Ergas, personal capacity, *Submission 42*, pp 5–6.

26 The LPI is also referred to as the Wage Price Index (WPI).

I note that the wages price index is just one measure of wages growth in the economy and it is not as broad as some other measures. The broader measures which are more likely to capture bonuses et cetera are more likely to be paid in the private sector. It may be that the wage price index is not a perfect measure of the entire payments for labour in the public and private sectors.²⁷

4.32 Nonetheless, the committee accepts that the LPI is indicative of relative trends of the labour price movements between sectors. Mr Ergas added detail to his explanation when he spoke of the factors feeding the growth:

It is always very difficult to say, but when you look at it there are a few components. One is that the composition of employment in state governments changed. That change in the composition of employment, with a reduction in the number of essentially unskilled and a relative growth in more skilled types of employment contributed to a growth in labour costs. At the same time, there was some shift within the public sector in the types of positions or areas and occupations which were growing, and that too made a contribution. But, finally, in a number of cases there did appear to be wage growth which was, when compared to the private sector, relatively generous.²⁸

4.33 Mr Ergas also expressed doubt about whether the increases in public sector wages have been sufficiently underpinned by increased productivity:

The difficulty also is that, in the private sector, there has been a closer link between increases in labour costs—or, rather, increases in remuneration—and increases in productivity. Of course, part of the problem in the public sector is that it is very difficult to measure productivity, so we do not know how close that relationship has been. But, if we look at outputs, we do not see outputs or outcomes increasing particularly rapidly. That is certainly not dispositive of the question but suggests that there may be real issues there about whether those increases have been justified by increases in the productivity with which services are being provided.²⁹

4.34 It would seem that substantially increased hospital waiting lists, worsening school performance are instances where increased wages costs have not increased productivity. The Australian Institute of Health and Welfare reported that last year, just 70 per cent of public hospital visits and just 65 per cent of urgent visits were seen

27 Dr Tony Richards, Head of Economic Analysis, Reserve Bank of Australia, *Committee Hansard*, 24 July 2008, p. 32.

28 Mr Henry Ergas, personal capacity, *Committee Hansard*, 25 July 2008, p. 51.

29 Mr Henry Ergas, personal capacity, *Committee Hansard*, 25 July 2008, p. 51. See also evidence from Ms Vicky Chapman MP, Deputy Leader of the Opposition for South Australia, *Committee Hansard*, 27 March 2008, p. 17.

on time.³⁰ Yet in several states and territories there are more health bureaucrats than hospital beds.³¹

4.35 According to the Ministerial Council on Employment, Education and Youth Affairs, between 2002 and 2005 (the four most recent years in which statistics are available), the percentage of Year 5 children who received benchmark results in reading and writing had declined overall and declined in the majority of States and Territories.³²

4.36 Yet in 2006–07, whilst the Australian Government increased funding by 11 per cent, the State and Territory Governments increased funding to schools by just 5 per cent – less than half of what was provided by the Commonwealth.³³

4.37 Evidence from Dr Steve Thomas MLA, Shadow Treasurer for Western Australia, added weight to Mr Ergas' doubts:

...of the additional public servants that are now employed, only a small proportion of those are frontline public servants and there is a significant rise of backroom Public Service operators. It is interesting that, when you see an economy booming, it is a bit like Murphy's Law: the amount of work for social workers effectively expands to fill the number of social workers you have got, and the same applies in relation to the general government sector. If the money is there, the departments are spending it and there is significant wastage in relation to additional public servants.

If you look at the advertising budgets, for example, they are rising constantly. If you look at the number of people sitting in offices that are providing policy direction, for example, they are expanding daily, and the number of public servants who are fulfilling roles that are not front-line public servants is increasing. There has been an increase in police, an increase in nurses and an increase in teachers, and they are all very welcome, but at the same time there has been a fourfold increase on top of that of everybody else...³⁴

-
- 30 Australian Institute of Health and Welfare, *Australian hospital statistics 2006-07*, Health Services Series No. 31, May 2008, p. 107, www.aihw.gov.au/publications/hse/ahs06-07/ahs06-07-c05.pdf (accessed 12 September 2008).
- 31 Australian Capital Territory Department of Health, *ACT Health Annual Report 2005–06*, p. 72; Northern Territory Department of Health and Community Services, *Annual Report 2006–07*, p. 117; Tasmania Department of Health and Human Services, *Annual Report 2005–06*, p. 15.
- 32 Ministerial Council on Employment, Education and Youth Affairs, *National Report on Schooling in Australia*, Preliminary Paper: National Benchmark Results: Reading, Writing and Numeracy, Years 3, 5 and 7, p. 25, www.curriculum.edu.au/verve/resources/ANR2007Bmrks-Layout_FINAL.pdf (accessed 9 September 2008).
- 33 The Hon Ms Julie Bishop, Minister for Education, Science and Training, *House of Representatives Hansard*, 13 February 2007, p. 20.
- 34 Dr Steve Thomas MLA, Shadow Treasurer for Western Australia, *Committee Hansard*, 12 June 2008, p. 10.

4.38 Shadow Finance Minister for New South Wales, Mr Mike Baird MP told the committee of the situation in his home state:

In relation to some of the [public sector] expense rises we have seen—and the total expenses have gone from \$36 billion to \$45 billion—the employee expenses have gone up at the highest rate, from \$18 billion to almost \$23 billion. The important point there is that those rises have grown at a much faster rate than the private sector.³⁵

4.39 The situation was mirrored in Victoria, where Mr Kim Wells MP, Victorian Shadow Treasurer submitted that:

The number of public servants has grown significantly from what it was in 1999. The Victorian Public Service wages bill is now \$12.2 billion. It is my understanding that, from 1999 to 2008, the Victorian Public Service has increased by between 64 000 and 65 000. We accept that there has been an increase of police of 1400 and an increase of teachers and nurses of between 5000 and 6000, and we understand that there has been an increase in public health allied workers. But I am unsure of the allocation of employment in other sectors of the Victorian Public Service.³⁶

4.40 In an attachment to his submission, Dr Flegg observed that labour costs taken together with other public service operating expenses in Queensland painted an even more dramatic picture. Total expenses grew by 10 per cent in 2004–05; 13 per cent in 2005–06; and 12 per cent in 2006–07. This spending represented an increase on forecast estimates of 3.4 per cent, 5 per cent and 4 per cent respectively over the same years.³⁷

4.41 Mr Mike Blake, the Auditor-General of Tasmania, made an obvious point but one worth noting:

I highlighted that the numbers of FTE [full-time equivalent employees] are growing and the salary costs are growing. I think there are good reasons why the money is being spent primarily in the education and health sectors and that has been well documented in this state. All I am trying to highlight is that, if that trend continues and your expenditure growth is higher than your revenue growth, at some point you hit a negative situation.³⁸

4.42 According to ABS data on Wage and Salary Earners in the Public Sector in Australia 2007:

35 Mr Mike Baird MP, Shadow Finance Minister for New South Wales, *Committee Hansard*, 24 July 2008, p. 3.

36 Mr Kim Wells MP, Shadow Treasurer for Victoria, *Committee Hansard*, 19 May 2008, p. 8.

37 Dr Bruce Flegg MP, Shadow Treasurer for Queensland, *Submission 37*, Attachment A, p. 6.

38 Mr Mike Blake, Tasmanian Auditor-General, *Committee Hansard*, 20 May 2008, p. 5.

- Between 1996 and 2007 the number of public sector employees in the Australian government decreased by 121 700. Over the same time public sector employees at state level increased by 210 700.
- Between 1996 and 2007 the amount spent by the Commonwealth Government on wages increased by 12 per cent. At the same time the state government wages bill increased by 95 per cent.³⁹

Unfunded superannuation

4.43 It is partly through the exclusion of superannuation liabilities from their calculations that some state governments are able to claim they hold no 'net debt' (ND), or even enjoy 'negative net debt'. As explained in chapter 3, ND often does not include liabilities which could be subject to significant actuarial recalculation.

4.44 Nonetheless, not all jurisdictions report single ND figures, making comparisons between states less straightforward. For example, the Australian Capital Territory (ACT) provides two ND calculations—one including superannuation, the other without. The reason for different reporting in the ACT is the establishment of a Superannuation Provision Account in which assets are placed for the purposes of meeting future superannuation liabilities. These funds cannot be used for any other purpose. Other jurisdictions report either a 'superannuation liability' or an 'unfunded superannuation liability'. The details on how assets and liabilities are held for the purposes of superannuation, compared to general operations, are widely dispersed across budget papers. There is little detail on what is counted or not counted for these definitions.

4.45 The Parliamentary Library compiled Table 4.5 to give the committee a broad picture of superannuation liabilities across the jurisdictions, using figures from the state budget paper balance sheet.

Table 4.5—Superannuation liabilities of the states and territories, 2007–08 to 2011–12

	2007-08	2008-09	2009-10	2010-11	2011-12	Notes
	\$m	\$m	\$m	\$m	\$m	
NSW	17 126	17 389	19 921	20 016	20 024	a, c
QLD	20 849	21 874	22 816	23 674	24 442	a
ACT	3 248	3 723	3 997	4 278	4 563	a
NT	2 303	2 371	2 430	2 479	2 519	a
SA	6 910	6 992	7 062	7 120	7 164	b, d
TAS	3 675	3 886	3 994	4 094	4 185	a
VIC	12 939	13 067	13 101	13 156	13 159	a, e
WA	5 366	5 170	5 088	4 972	4 860	b
Total	72 417	74 473	78 408	79 790	80 915	

Source: state and territory budget papers 2008–09.⁴⁰

39 Australian Bureau of Statistics, *Wage and Salary Earners: Public Sector*, Australia, 2007.

4.46 When these liabilities are incorporated into state ND figures,⁴¹ the 'before and after' comparison can be dramatic, as demonstrated in Table 4.6.

Table 4.6—Comparison of Net Debt incorporating superannuation liabilities and published Net Debt, 2007–08 to 2011–12

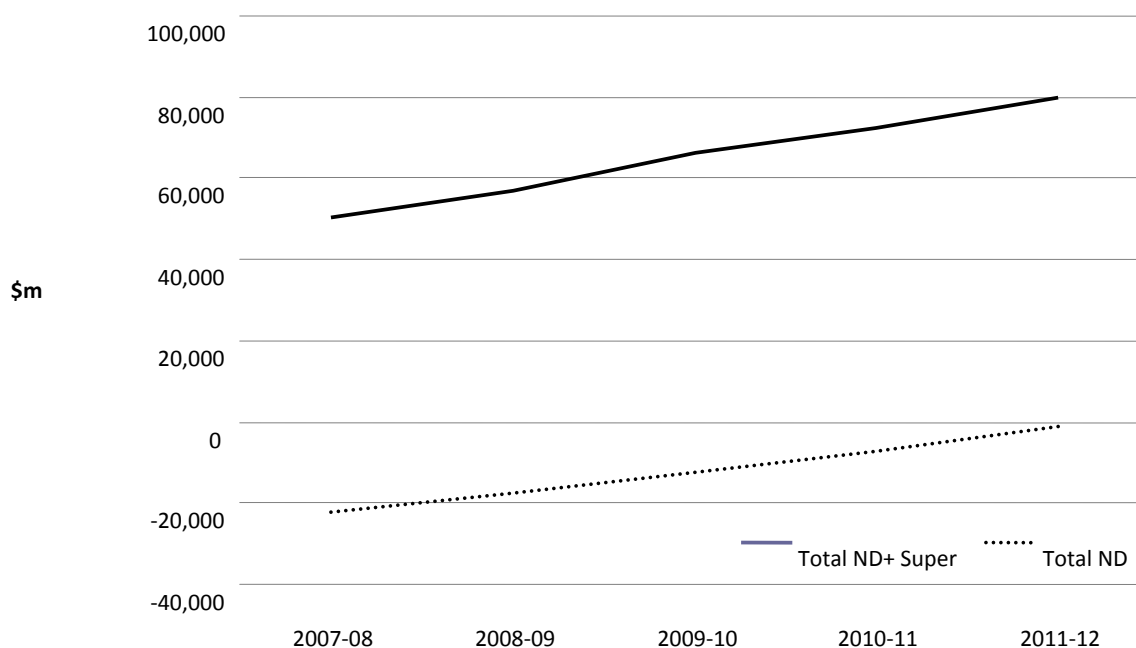
	<i>Net debt incorporating superannuation</i>					<i>Net debt as published</i>				
	<i>2007-08</i>	<i>2008-09</i>	<i>2009-10</i>	<i>2010-11</i>	<i>2011-12</i>	<i>2007-08</i>	<i>2008-09</i>	<i>2009-10</i>	<i>2010-11</i>	<i>2011-12</i>
	<i>\$m</i>	<i>\$m</i>	<i>\$m</i>	<i>\$m</i>	<i>\$m</i>	<i>\$m</i>	<i>\$m</i>	<i>\$m</i>	<i>\$m</i>	<i>\$m</i>
NSW	22 104	23 580	26 843	27 483	27 833	4 978	6 191	6 922	7 467	7 809
QLD	- 3 522	- 53	4 145	8 113	11 216	- 24 371	- 21 927	- 18 671	- 15 561	- 13 226
ACT	304	488	475	322	141	- 2 945	- 3 235	- 3 522	- 3 956	- 4 421
NT	3 385	3 417	3 426	3 409	3 367	1 082	1 045	996	929	848
SA	6 992	7 602	8 216	8 797	9 146	82	610	1 154	1 677	1 982
TAS	3 219	2 763	2 731	2 697	2 520	- 456	- 1 123	- 1 263	- 1 397	- 1 665
VIC	15 210	16 806	18 458	20 060	22 623	2 271	3 739	5 357	6 904	9 465
WA	2 486	2 509	1 994	1 721	2 906	- 2 968	- 2 749	- 3 182	- 3 339	- 2 042
Total	50 178	57 112	66 288	72 602	79 752	- 22 328	- 17 448	- 12 208	- 7 275	- 1 251

Source: state and territory budget papers 2008–09.⁴²

4.47 Plotted as an aggregate of all states and territories, the ND liability with and without superannuation is portrayed in Figure 4.6.

-
- 40 (a) Reported as superannuation liability.
 (b) Reported as unfunded superannuation liability.
 (c) NSW budget notes superannuation liabilities are reported net of prepaid superannuation contribution assets.
 (d) SA budget indicates a structural break in 2008 from the transfer of TransAdealide, the Adelaide Festival Centre Trust and the SA share of the Murray-Darling Basin Commission into the GGS.
 (e) The Victorian budget includes a detailed note on the superannuation system, indicating that the superannuation figure is net of assets, that is, assets held against superannuation.
- 41 The method used to achieve this incorporation is as follows: The sum of deposits held, advances received, government securities issued, loans and other borrowings; plus superannuation liabilities; less the sum of cash and deposits, advances paid, investments, loans made and placements.
- 42 Western Australia records a recurrent \$88 million figure for 'convergence differences impacting net debt'. Net debt is calculated in accordance with the description in chapter 3. Please refer also to notes from Table 4.4.

Figure 4.1—Comparison of published Net Debt and Net Debt incorporating superannuation liabilities, 2007–08 to 2011–12



Source: state and territory budget papers 2008–09.

4.48 Figure 4.1 demonstrates that, in 2008–09, for example, the ND position of *minus* \$17.4 billion (a surplus) reverses to a net debt position of \$57.1 billion, a difference of \$74.5 billion.

4.49 To take the Northern Territory example, while General Government Sector ND at 30 June 2008 is published at \$1.082 billion, the committee heard that an extra \$2.3 billion is owed in the form of superannuation liabilities.⁴³ In the 2002–03 Northern Territory Budget Paper No II, superannuation liability was projected to grow to \$1.45 billion by 2005–06. The final results for 2005–06 disclosed a figure of \$1.8 billion, and in 2007–08, \$2.3 billion.⁴⁴

4.50 The Tasmanian Auditor-General told the committee that the superannuation liability in Tasmania was \$3.6 billion, and that the state's reported ND did not include the liability.⁴⁵

4.51 In New South Wales, Mr Baird alleged that the government had inaccurately minimised the state's superannuation liability, explaining that:

43 Mr Terry Mills MLA, Leader of the Opposition for the Northern Territory, *Submission 39*, p. 3.

44 Mr Terry Mills MLA, Leader of the Opposition for the Northern Territory, *Submission 39*, p. 3.

45 Mr Mike Blake, Tasmanian Auditor-General, *Committee Hansard*, 20 May 2008, p. 9.

[mis-forecasting] significantly depresses the unfunded super obligations of the state going forward, which then creates the position that you do not need to contribute as much from an ongoing state budget. They changed the ageing population assumptions, against national trends, and the impact of that was almost \$3 billion in the estimate period. In terms of the forward estimate, their estimation of unfunded super obligations was \$12 billion; using the old accounting standards it was \$17 billion. So there is a huge requirement, which depresses it. It is a good example of the need for transparency.⁴⁶

4.52 Dr Flegg reported on a similar situation in Queensland:

We have seen in Queensland what would, if it were in the private sector, be called creative accounting. For years, certainly since the last downturn following the GST, we have seen the state government bring some \$22 billion worth of superannuation assets, positioned on the balance sheet, and the investment returns from that, which have been up to a maximum of 21 per cent, going straight to the bottom line as though they were tax receipts. That money is not available for any general government purpose; it belongs to the superannuants in the public sector. To my mind, that is misleading accounting. But now markets have changed, returns are negative. They are certainly below the long-term average and, in the recent past, have actually been negative. So they have introduced a different system.⁴⁷

4.53 It is interesting to note that the South Australian Government is reported in the *Adelaide Advertiser* of 1 September 2008 as having to fund an additional \$120 million for superannuation costs as a result of the international financial crisis.⁴⁸

Forecasting

4.54 In addition to evidence of 'creative accounting', the committee heard evidence of a growing tendency by a number of state and territory governments to underestimate revenue in their forward estimates. Mr Terry Mills MLA, Leader of the Opposition in the Northern Territory, submitted that:

...[T]he Territory has repeatedly and substantially underestimated its revenue outcomes. In Budget Paper II for the year 2004–05 the projected income for the year 2007–08 was \$2.77 billion, compared with the \$3.49 billion of the 2007–08 mid-year report.⁴⁹

4.55 The New South Wales Shadow Treasurer submitted that in his state:

46 Mr Mike Baird MP, Shadow Finance Minister for New South Wales, *Committee Hansard*, 24 July 2008, p. 4.

47 Dr Bruce Flegg, Shadow Treasurer for Queensland, *Committee Hansard*, 17 July 2008, p. 3.

48 Mr Greg Kelton, 'House slump to cost \$30m in tax revenue', *Adelaide Advertiser*, 1 September 2008, p. 2.

49 Mr Terry Mills MLA, Opposition Leader for the Northern Territory, *Submission 39*, p. 2.

Two continuing trends in the mis-forecasts are the windfall tax revenues and the continuing blowouts in expenses above budget targets. The 2006–07 expenses increase target of 5.7 per cent blew out to 5.9 per cent and the 2007–08 target of 3.6 per cent has already blown out to 6.8 per cent.⁵⁰

4.56 The Property Council of Australia submitted that, of the 56 state and territory budgets handed down since the introduction of the GST, subsequent property tax revenues were underestimated 91 per cent of the time.⁵¹

4.57 The committee was told of a number of instances of wages and other spending being mis-forecast. In 2005, employee expenses in the Northern Territory exceeded estimates by \$120 million, or 12 per cent.⁵²

4.58 While the committee can understand the desire to exercise caution in forecasting, the consistency and extent of under-forecasting revenue appears excessive. The committee makes the point that deliberately engaging in this practice misleads the public in exactly the same way as under-forecasting a deficit or debt result. Insofar as this detracts from the public having an accurate picture of the financial position of their state, it is equally as serious. The committee makes a recommendation (Recommendation 2) about improving state financial forecasting in chapter 8.

Income from the Commonwealth

4.59 Consistent with the relatively high level of Vertical Fiscal Imbalance discussed in chapter 2, Treasury submitted that total Commonwealth funding payments to the states for 2007–08, comprising GST revenue, general revenue assistance and Special Purpose Payments (SPPs) is expected to be \$73.1 billion.⁵³

4.60 The states will receive GST revenue of \$42.2 billion in 2007–08, an increase of 6.8 per cent from 2006–07. This is expected to be \$3.4 billion more revenue in 2007–08 than they would have received had the GST not been in place. These outcomes represent significant tax windfalls for the states over and above what they were forecast to receive at the introduction of the GST in 2000. Revenue from the GST comprises about 60 per cent of revenue received by states from the Commonwealth.⁵⁴

4.61 Commonwealth SPPs totalling \$30.3 billion were made in 2007–08, and SPPs should increase slightly to \$30.9 billion in 2008–09. Of these, the Commonwealth

50 The Hon. Greg Pearce MLC, Shadow Treasurer for New South Wales, *Submission 6*, p. 13.

51 Property Council of Australia, *Submission 30*, p. 1.

52 Mr Terry Mills, Leader of the Opposition for the Northern Territory, *Submission 39*, p. 2.

53 Department of the Treasury, *Submission 25*, p. 9. See also the table setting out Commonwealth funding in this section.

54 Associate Professor Graeme Wines, personal capacity, *Submission 17*, p. 5.

provided \$22.6 billion 'to' states and \$7.6 billion in payments 'through' the states to local government in 2007–08. In 2008–09, SPPs 'to' the states are estimated to be \$22.8 billion and payments 'through' the states to be \$8.1 billion.

4.62 Between 1997–98 and 2005–06, the Commonwealth provided \$4.9 billion in National Competition Policy payments to the states for implementing National Competition Policy and related reforms.

4.63 The annual amounts for each of these Commonwealth funded revenue sources are detailed in Table 4.7 for the period 2000–01 to 2010–11.

Table 4.7—Total Commonwealth funding, 2000–01 to 2010–11

(\$million)	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11
GST revenue	24,354.9	26,632.0	30,479.1	33,218.7	35,322.7	37,181.6	39,551.9	42,230.0	45,270.0	47,670.0	50,130.0
SPPs "to" the States	14,376.9	15,490.9	16,109.4	16,590.4	17,968.9	19,612.5	20,931.6	22,618.7	22,845.3	0.0	0.0
SPPs "through" the States	4,721.0	5,464.3	5,392.3	5,981.4	6,515.0	6,915.5	7,237.3	7,644.5	8,054.4	0.0	0.0
SPPs direct to local government	108.9	502.6	279.0	368.0	311.3	376.1	380.7	587.8	688.6	0.0	0.0
Other payments											
Special Revenue Assistance	13.5	14.2	-	-	-	-	-	-	-	-	-
Budget Balancing Assistance	2,818.1	4,093.8	994.0	68.8	-	-	-	-	-	-	0.0
National Competition Policy Payments	448.0	733.3	739.9	578.5	724.4	816.5	-	43.2	-	-	-
Compensation for GST Deferral measure	-	-	-	-	219.4	127.0	-	-	-	-	-
Residual Adjustment Amount	-	-	-	-	-	95.2	-	-	-	-	-
Total Payments	46,841.4	52,931.1	53,993.7	56,805.8	61,061.6	65,124.4	68,101.4	73,124.1	76,858.3	47,670.0	50,130.0

Source: Mid-year economic and fiscal outlook 2007–08 estimates, Commonwealth Treasury, *Submission 25*, p. 9.

State government taxes

4.64 State government taxation proceeds constitute a significant proportion of their total revenue. In New South Wales, revenue from taxation in 2008–09 is forecast to be 38.7 per cent of total revenue,⁵⁵ while the Queensland Government expects to raise 27.6 per cent of its revenue from tax in the same period.⁵⁶ In states relying more heavily on assistance from the Commonwealth, the figure is lower; in 2006–07 Tasmania derived 20 per cent of its income through taxation.⁵⁷

4.65 The sentiment of many submitters to the inquiry regarding state and territory taxation was summarised by the Real Estate Institute of Australia, which contended that:

55 New South Wales Government, Budget Papers 2008–2009, *Budget Overview*, p. 11.

56 2008–09 Queensland Budget Papers, *How the money is raised; How the money is spent*, www.budget.qld.gov.au/budget-papers/2008-09/budget-highlights-15-2008-09.pdf, (accessed 20 August 2008).

57 Tasmanian Audit Office, Report of the Auditor-General No. 2 of 2007, *Executive Summary*, November 2007, p. 29.

An ongoing lack of financial autonomy results in states and territories clinging to taxation regimes which are known to be distortionary and inefficient. While significant progress was made as a result of the implementation of the intergovernmental agreement underpinning the introduction of the GST, a raft of relatively inefficient state and territory taxes remain in place, with little prospect of removal in the absence of alternative revenue sources. These taxes include stamp duties on property conveyancing, land tax and payroll tax.⁵⁸

4.66 Mr John Nicolaou, representing the West Australian Chamber of Commerce and Industry, made his organisation's purpose clear:

What we are here to see is a more competitive tax regime. That is the central message that we have been trying to articulate for some time now. On a per capita basis, Western Australia is clearly the most uncompetitive state. In relation to tax as a percentage of the total economy, which Treasury now use as their benchmark, we do rank middle-of-the road, but that percentage is increasing, so we are moving up in terms of overall tax burden. The Commonwealth Grants Commission use a tax effort ratio and we rank as the highest taxing state.

...

Payroll tax is not a big business issue and it is a furphy to suggest that it is. It is a small business issue and it is having an impact at the margin on small businesses that are struggling to meet increased costs.⁵⁹

4.67 The Property Council submission argued that states and territories have relied too heavily on property taxes in recent history. In calling for the elimination of stamp duty on commercial conveyances and indirect property taxes, the Property Council informed the committee that, since the introduction of the GST, \$11.6 billion has been collected through property taxes over and above the amount anticipated. Land tax and conveyancing duty revenue are growing at more than double the average rate of all other state taxes combined.⁶⁰ The Property Council calculated that land taxes make up 37 per cent of all state and territory taxation revenue.⁶¹

4.68 Nor were industry groups the only witnesses to draw attention to these concerns. Victorian Shadow Treasurer, Mr Kim Wells MP had this to say:

I am very concerned about the reliance of the state budget on property taxes. I think the reliance on land tax and stamp duty was in the high teens in the late nineties; now the percentage is in the very high 30s. With increased interest rates, petrol prices, the CPI moving and pressure from

58 Real Estate Institute of Australia, *Submission 28*, p. 4. See also, for example, Insurance Australia Group, *Submission 10*, pp 1–2; Commerce Queensland, *Submission 4*, p. 4.

59 Mr John Nicolaou, Chief Economist, Chamber of Commerce and Industry of Western Australia, *Committee Hansard*, 12 June 2008, pp 44 and 50.

60 Property Council of Australia, *Submission 30*, p. 3.

61 Property Council of Australia, *Submission 30*, p. 5.

overseas markets, my concern is that, if the property market is hit and there is a slight downturn, there is going to be a significant impact on the Victorian budget because of its heavy reliance on property taxes.⁶²

4.69 The warnings of Mr Wells about over-reliance on stamp duty in the property boom were prescient. The *Adelaide Advertiser* of 1 September 2008 reports a reduction in that state government's revenue of \$30 million because of a downturn in the property market.⁶³

4.70 The negative impact of state taxes such as conveyance duties was not lost on the committee. A report on state taxation reform by Mr Robert Carling found that stamp duty on property conveyance:

...distorts choices between buying and renting and between moving house and staying put or renovating. It tends to lock householders into sub-optimal housing and militates against resource mobility. Marginal deadweight costs have increased over the years as a rising proportion of transactions have become subject to the upper levels of the progressive scales.⁶⁴

4.71 Another primary focus for criticism was payroll tax, the abolition of which a number of witnesses called for.⁶⁵ Mr Behrens, State Manager of Commerce Queensland, explored the common objections to the tax:

Payroll tax is the absolute standout, and the interesting thing is that, from our own surveys, it is identified by the entire business community as the tax that they would like to see removed. It is interesting because 95 per cent of Queensland businesses do not pay payroll tax, yet they are citing payroll tax as a major concern. We were very curious as to why, so we explored it and we came up with three reasons. The first one is that, ultimately, they are a small business and they aspire to grow, so eventually they may pay payroll tax. The second one is that they do receive some of the indirect windfall or benefit of the tax cut in that big business does do business with smaller sized enterprises, who receive some indirect benefit. The third one is a

62 Mr Kim Wells MP, Shadow Treasurer for Victoria, *Committee Hansard*, 19 May 2008, p. 17. See also Ms Vicky Chapman MP, Deputy Leader of the Opposition for South Australia, *Committee Hansard*, 27 March 2008, pp 25–26.

63 Mr Greg Kelton, 'House slump to cost \$30m in tax revenue', *Adelaide Advertiser*, 1 September 2008, p. 2.

64 Mr Robert Carling, *State Tax reforms: Progress and Prospects*, 2008. See also Mr Robert Carling, personal capacity, *Submission 27*, Attachment B, p. 10. See also Australian Industry Group, *Submission 21*, p. 3

65 See, for example, Mr Nick Behrens, State Manager, Commerce Queensland, *Committee Hansard*, 17 July 2008, p. 15; Mr Paul Bidwell, General Manager, Commerce Queensland, *Committee Hansard*, 17 July 2008, p. 16.

principle—that ultimately it is a tax on economic growth and it is a tax on employment. So they have this principle that it should be removed.⁶⁶

4.72 Other witnesses called for payroll tax rates and thresholds in their state to be modified, primarily for reasons of inter-state competition. Mr Kim Wells MP, Shadow Treasurer in Victoria, remarked that:

To the government's credit, they have cut payroll tax from five per cent to 4.95 per cent, so it is under the five per cent range—and it has not been that way for some time. But the problem is that the threshold of \$550,000 has not changed. So, as small businesses pay their employees pay increases, more and more small businesses will be caught up in the payroll tax net... more small businesses are paying payroll tax. A small business in this state is a business that has 20 or less. So 20 or less means that obviously more and more small businesses are paying payroll tax. The issue is that we welcome the cut of the rate, but the threshold has not been adjusted, and that is where they are getting more. In fact, despite the cut, with payroll tax they will collect an extra \$200 million from businesses in Victoria.⁶⁷

4.73 Mr Mike Baird MP echoed this call:

We did see a reduction in payroll tax in the last state budget. We went from six per cent down to 5.75 per cent, and the closest state is Victoria at 4.95 per cent. So we are still a long way from parity in relation to payroll tax. Again, I think that is something you need to look at federally. There needs to be harmonisation. A company operating across Australia will see huge differences in relation to payroll tax rates and thresholds. It is the most inefficient system we have spoken about.⁶⁸

State income tax

4.74 At various stages during the inquiry, particularly in discussions about Vertical Fiscal Imbalance, the prospect of states levying their own income tax was raised. Realistically, this would likely require the Commonwealth to 'make room' for the states by lowering personal income tax rates. In 1978, the Fraser Government legislated to allow the states to impose an income tax surcharge in order for the states to broaden their own-source tax base. The initiative failed partly because the Commonwealth did not cut tax rates to make room for surcharges.⁶⁹

4.75 As discussed in chapter 2, Vertical Fiscal Imbalance reflects the larger stream of revenue flowing to the Commonwealth relative to the states. The committee's

66 Mr Nick Behrens, State Manager, Commerce Queensland, *Committee Hansard*, 17 July 2008, pp 22–23.

67 Mr Kim Wells MP, Shadow Treasurer for Victoria, *Committee Hansard*, 19 May 2008, pp 4–5.

68 Mr Mike Baird MP, Shadow Minister for Finance for New South Wales, *Committee Hansard*, 24 July 2008, p. 11.

69 Scott Bennett and Richard Webb, *Specific Purpose Payments and the Australian federal system*, Parliamentary Library Research Paper no. 17, 2007–08, p. 17.

interest in states levying their own income tax lies with the prospect of reducing the imbalance and alleviating some of its effect.

4.76 One advantage of states levying a surcharge would be that the cost of administration would not increase greatly if the base rate was unchanged and identical across the states, and the Commonwealth administered and collected the tax. Another possible advantage is that competition among the states would be likely to put downwards pressure on surcharge rates.

4.77 A state surcharge could, however, face considerable barriers because it would entail a fundamental change to Commonwealth-state financial arrangements. That would require the agreement of all jurisdictions which may not be forthcoming. Indeed, the Deputy Leader of the Opposition in South Australia, Ms Vicky Chapman, remarked that any government seeking to introduce income tax might be said to have a 'death wish'.⁷⁰ On the other hand, Dr Steve Thomas, Shadow Treasurer in Western Australia expressed a personal view that, while it would likely be impossible to manage, it would be a good idea.⁷¹

4.78 The Institute of Public Affairs, called for the complete abandonment of income tax collection by the Australian Government to enable the states to levy their own. The IPA argued that:

In addition to exiting the provision of social services, health and education the Commonwealth should give up all its personal income tax powers. This would enable the states and territories to levy their own personal income taxes. This would also allow the states and territories to give up the inefficient transactions taxes that they currently levy. The Commonwealth should continue to levy the corporate income tax and GST and other excise taxes that it currently levies and should continue to allocate funds (in excess of its own requirements) to the states and territories. Using the 2007-08 Budget papers as a guide this implies that the Commonwealth would give up almost half (excluding the GST) of the revenue it currently raises. In contrast by exiting its redistributive functions the commonwealth would reduce its own expenditure by almost two-thirds. In other words there may still be a large role for the Commonwealth in allocating funding to the states and territories.⁷²

4.79 Professor Sinclair Davidson, Economist with the Institute of Public Affairs, elaborated on the IPA's submission at the Melbourne hearing:

Our argument is that we should push down some level of taxation. Within Australia, if we think back to the Australian Constitution and what it is

70 Ms Vicky Chapman MP, Deputy Leader of the Opposition for South Australia, *Committee Hansard*, 27 March 2008, p. 32.

71 Dr Steve Thomas MLA, Shadow Treasurer for Western Australia, *Committee Hansard*, 12 June 2008, p. 17.

72 Institute of Public Affairs, *Submission 30*, p. 6.

designed to do, it is effectively designed to create a common market within the six former colonies and the territories, which basically means that the Commonwealth or the federal government should be looking after common market activities. It should be looking after corporates, which it does, and therefore our argument is that the Commonwealth should retain the corporate income tax power. But individuals are located within states and therefore the states should have the personal income tax power.⁷³

4.80 While the committee was not in a position to explore in detail the possibilities of states introducing an income tax levy, the concept has some obvious appeal. Put simply, it has the potential to significantly reduce or bring an end to the funding 'blame game' between states and the Commonwealth. Were states to receive income tax revenue in the same way they receive GST revenue, they would be forced to manage their own budgets without recourse to criticising a 'donor' Commonwealth.

4.81 The committee recommends that the Commonwealth Government seriously consider all aspects of the states accessing income taxation powers at Recommendation 7.

4.82 Even taken alone, the prospect of reforming the tension between the Commonwealth and states over funding suggests to the committee that the concept of state income tax deserves further exploration.

4.83 Another possible advantage is the prospect of encouraging competition between the states for residents, through the establishment of the most efficient taxation regime. Far from being mere 'pie in the sky', Professor Davidson reminded the committee of the situation in Switzerland:

There may actually be some population movement around that, and that is normally the argument—that there would be a race to the bottom. Yet if we look at the Swiss, who have a confederation, and their cantons, some of the richer cantons actually have higher levels of taxation than others and the rich are not stampeding out of the doors. People actually trade off tax against what they are getting.⁷⁴

Local government

4.84 The Australian Local Government Association (ALGA) made a number of points to the committee. Principal among these was that services provided, and infrastructure owned and operated, by local government is critical to the efficient operation of the Australian economy, as well as to meeting the social and other needs

73 Professor Sinclair Davidson, Economist, Institute of Public Affairs, *Committee Hansard*, 19 May 2008, p. 24.

74 Professor Sinclair Davidson, Economist, Institute of Public Affairs, *Committee Hansard*, 19 May 2008, p. 26.

of citizens.⁷⁵ This is particularly the case where other levels of government have withdrawn services from isolated and rural shires.⁷⁶

4.85 To this end, the adequate and efficient funding of local government is critical. The committee was reminded by the ALGA of the effect cost shifting between jurisdictions has on local government bottom lines, and on that level of government's ability to provide services to ratepayers.⁷⁷

4.86 The ALGA was confident that a new agreement between local government and state planning ministers would help avoid cost shifting in the future.⁷⁸ The committee is pleased to hear that progress is being made to reduce cost shifting, an inherently inefficient practice that helps nobody in the longer term. This is referred to in Recommendation 6 which appears in chapter 8.

4.87 The Commonwealth Grants Commission have indicated that states have recently stepped up the practice of shifting costs onto local councils. One example is the reduction in funding for libraries, forcing councils to assume extra responsibility, rather than having those services withdrawn from their communities.⁷⁹

4.88 The House of Representatives Standing Committee on Economics, Finance and Public Administration noted in its 2003 *Rates and Taxes* report that:

There is no doubt that local government has, over a number of years, been on the wrong end of cost shifting largely by State governments. The Commonwealth Grants Commission has recorded that over the last 25 years the Federal government has, in real terms, progressively increased its contribution to local government while State contributions have not grown.⁸⁰

4.89 The committee also heard evidence of a lack of transparency on the part of state governments in the provision of funding to local councils. This was of particular interest to the committee, because much of the funding in question originates from the Commonwealth. The ALGA submitted that:

75 Australian Local Government Association, *Submission 33*, Attachment A, pp 1–4.

76 Professor Brian Dollery, *Submission 20*, Attachment B, Dollery, Byrnes and Crase, *Resolving the Australian Local Infrastructure Crisis through a Federal Infrastructure Asset Fund*, p. 5.

77 Australian Local Government Association, *Submission 33*, Attachment A, p. 2.

78 Australian Local Government Association, *Submission 33*, Attachment A, p. 2.

79 House of Representatives Standing Committee on Economics, Finance and Public Administration, *Rates and Taxes: A Fair Share for Responsible Local Government*, October 2003, p.34.

80 House of Representatives Standing Committee on Economics, Finance and Public Administration, *Rates and Taxes: A Fair Share for Responsible Local Government*, October 2003, foreword.

Currently, the Commonwealth provides general-purpose funding to local government via the States [Financial Assistance Grants], which then administer the funding following recommendations made to the Commonwealth Minister by Local Government Grants Commissions established in each State... [Because funding is] paid initially to the states to distribute to councils, some states have treated these grants as payments to local government from the state government. This is misleading and in the absence of better accounting treatment rules and...there is a real risk of double-counting...aggregate fiscal data for local government provide a misleading picture which overestimates the states' financial contribution to local government and undermines efforts to establish a true picture of local governments' financial circumstances.⁸¹

4.90 Should the ALGA's submission be accurate, and the committee has no reason to think otherwise, the states are engaging in practices that are at best sloppy and at worst duplicitous. The committee recommends that the Government take the opportunity to specifically address the issue of identification of Commonwealth funding through its planned SPP reform program at Recommendation 11 in chapter 8.

Conclusion

4.91 During the course of the inquiry, a number of significant financial management issues were brought to the committee's attention. The committee is mindful of evidence received from a variety of witnesses that debt, incurred for the enhancement of productive capacity, is a sign of responsible economic management. While the committee is heartened by the evidence from some submitters that debt levels in states and territories are relatively manageable, it notes that witnesses generally made their assessment based on a comparison with historic levels.

4.92 Recent revelation by the former NSW Treasurer in his resignation media conference mirror the alarm of many of the witnesses. In a revealing parting shot at the State's parlous fiscal position, the Hon Michael Costa said that Stamp Duty had fallen \$180 million in the first 2 months of this financial year, the Health Budget had blown out by \$300 million this year with a \$5 billion capital funding shortfall over the next 5 years causing Standard and Poor's to warn that there was a 1 in 3 chance of NSW losing its AAA rating which would in turn raise borrowing costs by over \$500 million over the forward estimates.⁸²

4.93 Memories of the irresponsibly high levels of debt incurred by some states in recent decades should serve as a warning to those seeking to minimise concern at the rising levels of debt revealed in this report.

4.94 Increases in public sector wage expenditure appear, in some jurisdictions, to be excessive. The proportion of budget expenditure going to fund the public sector is

81 Australian Local Government Association, *Submission 33*, Attachment A, pp 3–4.

82 Tracy Ong, 'Parting shot on credit rating', *Australian Financial Review*, 6 September 2008, p. 5.

significant, meaning that even modest wage increases can have dramatic affects on the budget bottom line. As well as the obvious impact wage rises have on inflation, the committee notes the considerable danger posed by continuing blowouts to states' fiscal health.

4.95 States employ various means of accounting for their superannuation liabilities. Not all of these are transparent, and the committee encourages the respective governments to take an honest and transparent approach with their constituents on what, in some cases, are very large superannuation liabilities to be met in coming years. The committee takes a similar view on the issue of inaccurate forecasting. Recommendations contained in chapter 8 seek to address these matters, as well as those concerning the states' fiscal relationship with local government, through the adoption by each state of a charter of budget honesty.

4.96 The committee's overall perspective, in a time of increasing state GST receipts, combined with increasing non-GST revenue, increasing debt, and excessive wages growth, was perhaps summarised best by Mr Ergas, who observed that:

These trends suggest significant scope for improved efficiency in financial management at the state and territory level. The concern is not simply with the deterioration in the fiscal position, though this is significant in terms of macroeconomic policy, given the pro-cyclical nature of the current deterioration. Rather, further concern arises to the extent that this deterioration is symptomatic of basic failures of governance at the state and territory level, also reflected in their poor management of infrastructure investment.⁸³

4.97 It is to infrastructure, often operated through Government Business Enterprises, that the committee now turns.

83 Mr Henry Ergas, personal capacity, *Submission 42*, p. 5.

