STANDARD & POOR'S

RatingsDirect®

March 16, 2006

System Support And Predictability For Australian State Governments

Primary Credit Analysts:
Danielle Westwater, Melbourne (61) 3-9631-2036; danielle_westwater@standardandpoors.com
Brendan Flynn, Melbourne (61) 3-9631-2042; brendan_flynn@standardandpoors.com

Table Of Contents

System Support And Predictability For Australian State Governments

Among the World's Strongest

Perhaps surprisingly, given public sniping between the Australian Commonwealth and state governments, Standard & Poor's considers Australia's system support and the predictability of Commonwealth-state relations as one of the strongest in the world. The system is characterized by transparent political and economic relationships between the Commonwealth and the individual governments of the eight states and territories (the states).

The Commonwealth's long-term local currency and foreign currency ratings are both AAA/Stable/A-1+. Providing the credit rating on the Commonwealth of Australia does not fall below 'AA-', it is difficult to see one of the state's falling below the 'AA' category, based on Standard & Poor's assessment of the Australian states' system of support and predictability.

For example, even during the hard times in the early 1990s, when the states undertook prolonged deficit spending, no rated Australian state was downgraded below the 'AA' category. Moreover, at that time, the Commonwealth's long-term local currency rating was 'AA+' (raised to 'AAA' in 1992) and its foreign currency rating was 'AA'.

There are a number of factors Standard & Poor's considers when assessing the strength of the Australian inter-government system:

- Predictability and checks and balances;
- Intergovernmental relations;
- Equalization systems;
- Revenue-expenditure match;
- Fiscal management (regulatory control framework);
- Transparency and planning; and
- Emergency support procedures.

Highly Predictable System of Government

The states benefit from a political environment with few appreciable risks. Australia has a stable and predictable political system with a strong institutional framework and broad consensus on conservative macroeconomic policies. The Australian governments pursue orthodox and predicable economic policies, and respond quickly to changing economic and political circumstances. Standard & Poor's believes that Australian governments would pursue difficult policies to avoid default, if these were required.

The powers of the Commonwealth and state governments are articulated in the Australian constitution, augmented by a century of slowly evolving precedent. The states have a large degree of constitutional autonomy under the Australian federal system of government.

Co-operative Relationship Between the States and Commonwealth

Intergovernmental financial arrangements are a supportive credit factor for the states and while there is generally a co-operative relationship, there is always a level of tension between the two tiers of government. This tension arises because the states always feel they need greater redistribution from the Commonwealth, particularly in response to what are often public disagreements over costs shifting from the Commonwealth to the states. There has also been a long-running trend of a centralization of power in the Commonwealth from the states via specific-purpose grants (tied grants).

The current, somewhat unusual, situation at present also adds to tension between the two tiers. Whereas the Commonwealth government is run by the conservative Liberal/National coalition, all the eight states and territories are governed by the main opposition social democrat Labor Party. This state of affairs has led to increased public sniping between federal and state governments, stemming from the states' dependence on the Commonwealth government for a substantial proportion of their revenues. Nevertheless, effective government is not threatened at either the state or federal level, and this noise is largely political point scoring.

Revenue/Expenditure Mix A Weakness

As the Commonwealth retains most revenue power (for example personal income tax, corporations tax and GST), but the states are responsible for major spending (for example, education, health, and the provision of basic services) some imbalance exists in the system. Despite this, the mismatch between revenues and expenditure responsibilities (vertical fiscal imbalance) has not been a constraint on strong fiscal management. A substantial program of grants from the Commonwealth to the states addresses this mismatch.

Equalization System Provides A Safety Net

Australia adopts a supportive system of fiscal equalization. The system allocates a substantial portion of funding (mainly GST) using a relativity score, and, according to the Commonwealth Grants Commission Report on State Revenue Sharing Relativities, 2006 Update, to "provide states with the capacity to provide the Australian average level of services if they make the Australian average effort to raise revenue and operate at the average level of efficiency". This system institutes a safety net for each state if its capacity to provide services to its residents, relative to the Australian average level, weakens.

The Commonwealth government distributes funding to the states under a methodology administered by the independent Commonwealth Grants Commission (CGC). This methodology system takes into account a wide range of factors such as demographics and geography, and replaced a system of Financial Assistance Grants negotiated annually between the Commonwealth and the states. Under this system, in place since the 1999 tax reform, the quantum of funding transferred to all states is largely driven by GST collection.

As an example, Queensland receives more than its average population share of GST revenue because the CGC believes Queensland requires a greater level of funding in order to broadly have the capacity to provide an 'Australian average level' of services. This belief is based on Queensland's revenue-raising ability and state specific factors affecting the cost of providing services such as the highly geographically dispersed population (See Table 1). For more detailed discussion of CGC funding see Credit FAQ: Australian States And The Commonwealth Grants

Commission, Ratings Direct, March 14, 2006.

In general, about one-half of the states' general government revenues are made up of grants. Because of the redistribution of these funds under the equalization system, the funds received by any one state are not closely correlated with the level of economic activity in that state alone. Moreover, the structure of these transfers ensures that any positive impact of a strong economy is counterbalanced by reductions in the state's share of Commonwealth funding over time. An underperforming economy relative to the national average (which decreases own-source revenue) would be counterbalanced by an increase in a state's share of Commonwealth funding over time.

Table 1.

Fiscal 2005 (Actual) Commonwealth Grant Revenues, Specific and General

State	Total grants and subsidies (mil. A$)*	Total Grants and subsidies/total revenue (%)*	State relativity¶
New South Wales	18,783	45	0.87
Victoria	13,463	45	0.87
Queensland	12,746	46	1.06
Western Australia	6,815	48	1.03
South Australia	5,418	51	1.20
Tasmania	2,115	63	1.56
Australian Capital Territory	1,127	47	1.13
Northern Territory	2,151	79	4.27

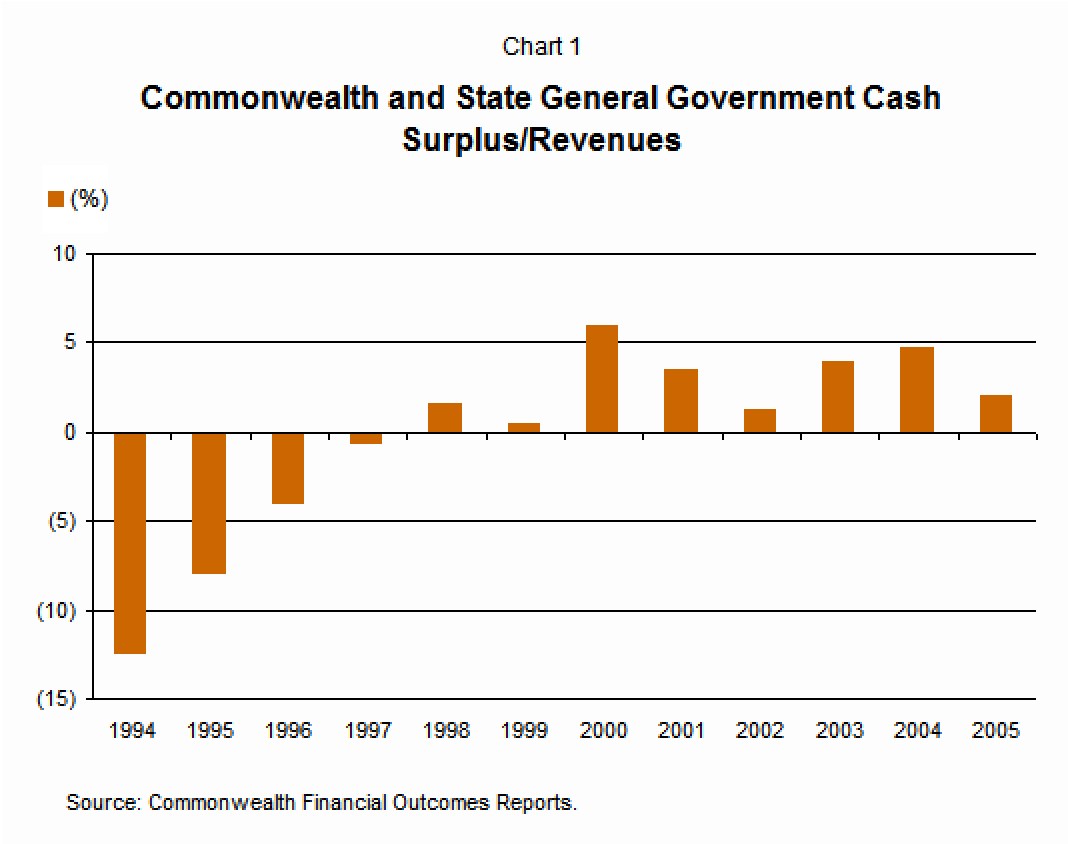
*General Government. ¶Commonwealth Grants Commission – Report on State Revenue Sharing Relativities, 2005 Update (2004 Review).

The state ratings are likely to remain bunched under the current system, whereby states with stronger capacities to provide the 'Australian average level' of services to its population offset those states with weaker capacities. For example, in fiscal 2005 NSW receives 87% of the average per capita grant, while Tasmania received 156% (see table 1). The appropriateness of the distribution relativities has been challenged strongly by New South Wales and Victoria (the two most populous states) particularly concerning the relativities of Queensland and Western Australia. Standard & Poor's believes that if the methodology underlying the relativities is reviewed and changes made, it is unlikely that the states most in need of funding will be substantially disadvantaged.

Political Will For Fiscal Sustainability

After the severe impact of the early 1990s recession on state government finances, exacerbated in some states by problems with their financial institutions, the emphasis among state governments shifted to fiscal consolidation (albeit pursued with more vigour in some states than others). This consolidation process, combined revenues from widespread privatization of state-owned businesses and robust economic growth, put most states' finances into balance or near balance by fiscal 1998.

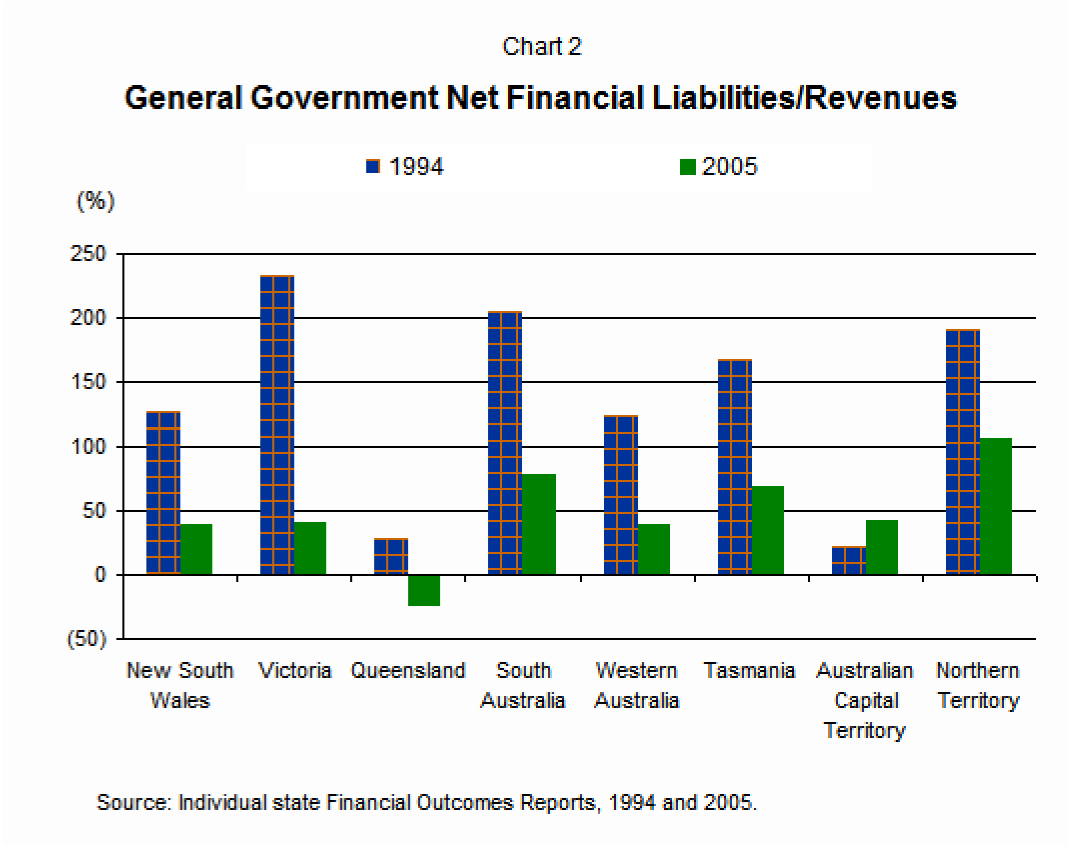
Chart 1



Part of the consolidation process involved the states re-building their finances and reducing their debt and other obligations. This was a major factor leading to rating upgrades (See chart 2).

In 2006, the financial outlook for all rated state governments is very strong and they are all in robust financial positions. Indeed, it has been an important political tool for Australian state governments to maintain or attain an 'AAA' rating. This goal is enshrined in many of their 'Fiscal Frameworks'.

Chart 2



Although there remains pressure for spending and tax cuts from opposition and various interest groups (especially with three states holding elections in 2006), Standard & Poor's is confident that the states' recent track record of fiscal constraint will continue, irrespective of election outcomes.

Environment of Transparency and Planning

Consistency and transparency in state reporting are key credit strengths. A uniform presentation standard is adopted by all states (Government Finance Statistics) ensuring accrual accounting and full corporate-style balance sheets. All state government annual reports are audited; indeed, some states also submit their budget to audit for annual review.

Each state prepares an annual budget, mid-year review, and annual report. These reports show both general government and consolidated financial statements (general government and nonfinancial public-sector corporations), with budgets and mid-year reviews reporting three-year general government forecasts and at least one year consolidated forecasts.

States moved to accrual accounting in the late 1990s or early 2000s. With this move, state governments adopted the corporate approach of expensing items as they occur, even though the associated cash outlay may take place some time later, and record a "provision" as a liability on the balance sheet. Standard & Poor's takes comfort from such provisioning practices, as it provides a transparent estimate of future obligations. Indeed, the growth in such provisions can adversely affect credit quality because satisfying these liabilities when they crystallize at some later date will require cash that might otherwise be needed to meet debt obligations. For example, the fiscal impact of an A$10 million provision for landfill remediation, where the landfill has an expected life of five years, has some similarities to the rollover risk associated with a five-year A$10 million debt instrument.

The move to accrual accounting also prompted the states to think about the longer term, and not just about their immediate debt liabilities. This crystallization of obligations in years to come brought into focus the looming problem of unfunded superannuation (pension) liabilities. To address this issue, the states first closed their generous superannuation defined benefit schemes and began defined contribution plans for new employees. Next they started setting aside money for accruing liabilities as they were incurred, and finally they began putting aside away extra cash, as part of a formalized funding plan as well as opportunistically, to make up for past accrued liabilities. This preparation is a major credit strength for the states, and Standard & Poor's fully considers unfunded superannuation in its assessment of a state's obligations (See Methodology for Assessing Australian States' Debt Burden, RatingsDirect, Feb. 23, 2006)

The states also consider off-balance-sheet liabilities, such as operating leases. This allows Standard & Poor's to take a whole-of-balance sheet approach to analysis and helps to highlight non-debt risks to credit quality.

Emergency Support

There are no formalized bailout procedures in Australia whereby the Commonwealth guarantees state debt. Despite this, Standard & Poor's believes that a high level of informal Commonwealth support exists, and that the Commonwealth would probably provide emergency support to the states, if required.

Table 2.

Australian States and Territories, Long-Term Local Currency Ratings -- 1994 and 2006

	2006	1994	Change in Notches
Australia (Commonwealth of))	AAA	AAA	
New South Wales (State of)	AAA	AAA	
Victoria (State of)	AAA	AA	+2
Queensland (State of)	AAA	AAA	
Western Australia (State of)	AAA	AA+	+1
Australian Capital Territory (Government of)	AAA	AAA	
South Australia (State of)	AAA	AA	+1
Tasmania (State of)	AA+	AA-	+2
Northern Territory	Not Rated	Not Rated	

* *