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Financial Flexibility: A Weak Point For All Australian States

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Financial flexibility is one of a number of inter-linked factors that Standard & Poor's considers when assigning a credit rating to a regional or local government.

A regional or local government's fiscal flexibility largely refers to its ability to adjust its levels of revenues and expenses (Rating Regional and Local Governments, RatingsDirect, Jan. 17, 2003). An assessment of fiscal flexibility includes consideration of:

- Legal limitations;
- Political/competitive limits; and
- Volatility.

Standard & Poor's believes that the Australian states and territories (the states) have limited fiscal flexibility, primarily resulting from the Australian institutional environment. In this environment, the Commonwealth of Australia holds most of the taxation powers, whereas the states have most of the responsibilities for delivering services.

This article explores how Standard & Poor's analyses the states' fiscal flexibility. Although the states' fiscal flexibility tends to be a systemic weakness, a number of other factors, including strong fiscal management within the institutional constraints, have ensured that the states have been assigned high ratings.

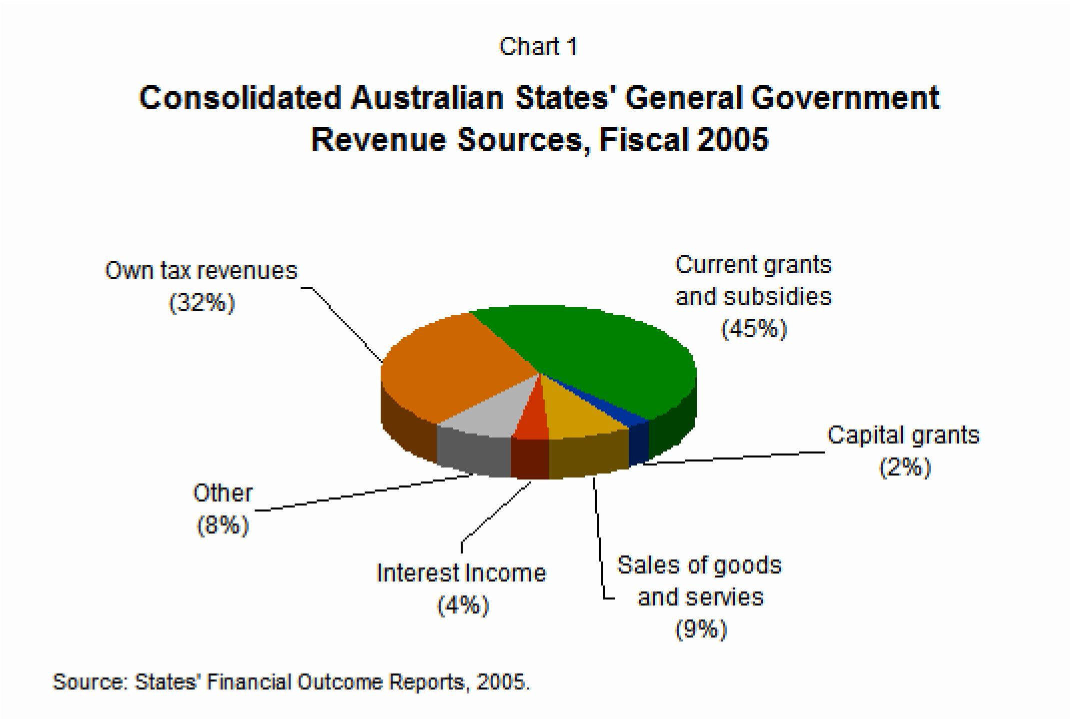
Revenue

On average, about half the states' revenues come from the Commonwealth in the form of grants (tied or untied), so the states essentially control only half their revenue base. This level of dependence on the Commonwealth for funding is a credit weakness.

The states' reliance on Commonwealth grants arises because the Commonwealth has the majority of taxation powers (for example, personal income tax, GST, and corporate tax). This means the states are exposed to changes by the Commonwealth in the size of the grants to all states, as well as to the size of grants to individual states. While this can introduce some degree of volatility to their revenue streams, Standard & Poor's does not believe that any ratings would be threatened in the event of a modest change in grant levels (See System Support and Predictability For Australian State Governments, RatingsDirect, March 17, 2006).

Of the revenues the states do control, taxation revenue, on average, is about 30% of the revenue base. Other 'own source revenues' (including dividends from publicly owned corporations and royalty income) and sales of goods and services (including rental income and fees and charges for services) largely make up the remainder of state earnings (see chart 1).

Chart 1



Standard & Poor's, by and large, considers reliance on revenue from government-owned corporations as a credit weakness. This is because there is a trade-off between the benefits of diversity of revenue provided by dividends and business risk associated with government ownership of public corporations. The revenue generated by public corporations are subject to higher risk than standard government taxes and charges.

Aside from risks stemming from owning public corporations, the broader a state's revenue base the more financial flexibility it achieves. A diversified revenue base tends to mitigate fluctuations or shortfalls in any one individual revenue stream.

The states remain under pressure from the Commonwealth to review the abolition of a number of their taxes, as agreed under the Intergovernmental Agreement on the Reform of Commonwealth State Financial Relations (IGA). Not only will abolishing own-source revenues increase states' dependence on the Commonwealth, it is also likely to have a transitional financial impact on the states. For example, in South Australia's fiscal 2006 budget, the taxes that South Australia cut or abolished under the IGA agreement were expected to total A$139 million in fiscal 2005, or about 5% of general government budgeted taxation revenue.

Despite these limitations, the states do have some revenue flexibility:

- There are no legal limits on state government taxes,, but there are practical limits. Although a state with lower tax collections per capita has stronger revenue flexibility than a state with higher tax collections per capita, all states are faced with competitive and political pressures. There is potential for an individual state to offer tax holidays, or reduce taxes relative to their peers in order to attract residents or business. That said, the states have historically been conservative in offering tax holidays.
- The states have minimal exposure to economic cycles. The performance, structure, and future prospects of the

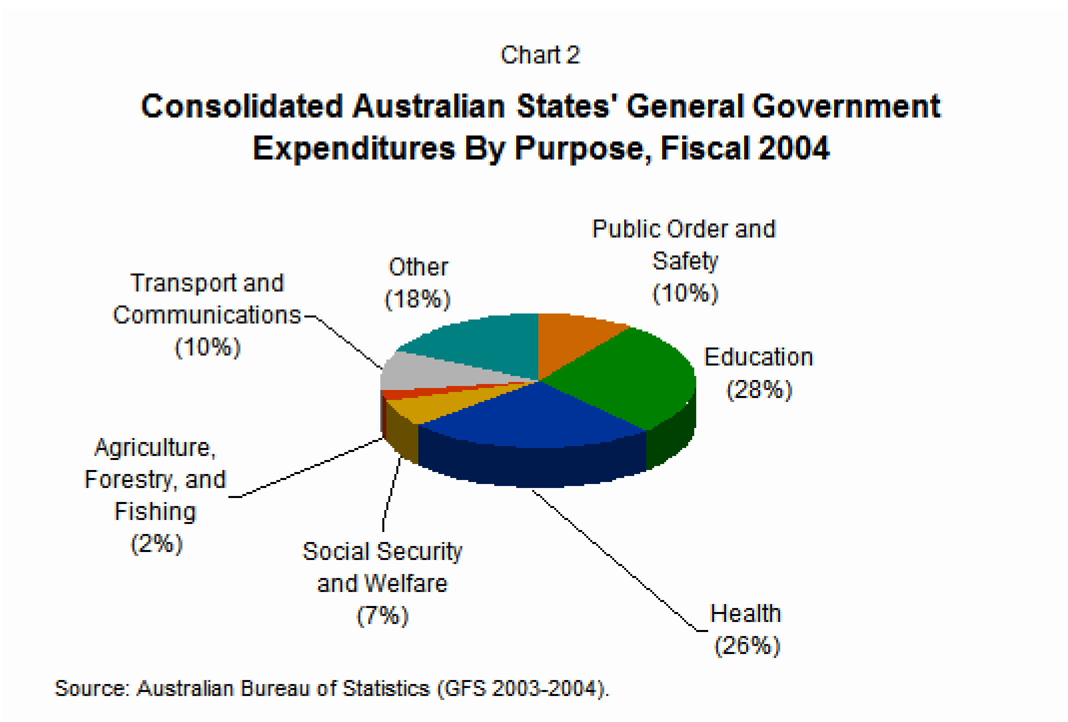
state economies have only limited direct impact on the state's finances as nearly half general government revenues are grants from the Commonwealth, which are not significantly correlated to the level of state economic activity. Revenue sources linked to areas such as property cycles or royalty revenues can expose the states to a degree of volatility; however, the states have historically been prudent in their forecasting of these revenues.

For example, volatility in own-source revenue can be demonstrated by looking at New South Wales' revenues from property transfers for fiscals 2004 and 2005. New South Wales' actual 2005 revenues from property transfers were lower than forecast in the state's budget. As a result of the weaker-than-forecast property market, transfer duty dropped by about A$600 million, or 4% of general government state taxation. In contrast, New South Wales' actual 2004 transfer on property transfers were higher than forecast in the state's 2004 budget. As a result of a stronger-than-forecast property market, transfer duty increased by about A$540 million, or 3.5% of general government state taxation.

Operating Expenditure

Although the Commonwealth has most of the revenue-raising powers, the states have a majority of the "big-ticket" spending responsibilities--both essential and politically sensitive services that are reined in only with difficulty. These services include health and education (see chart 2).

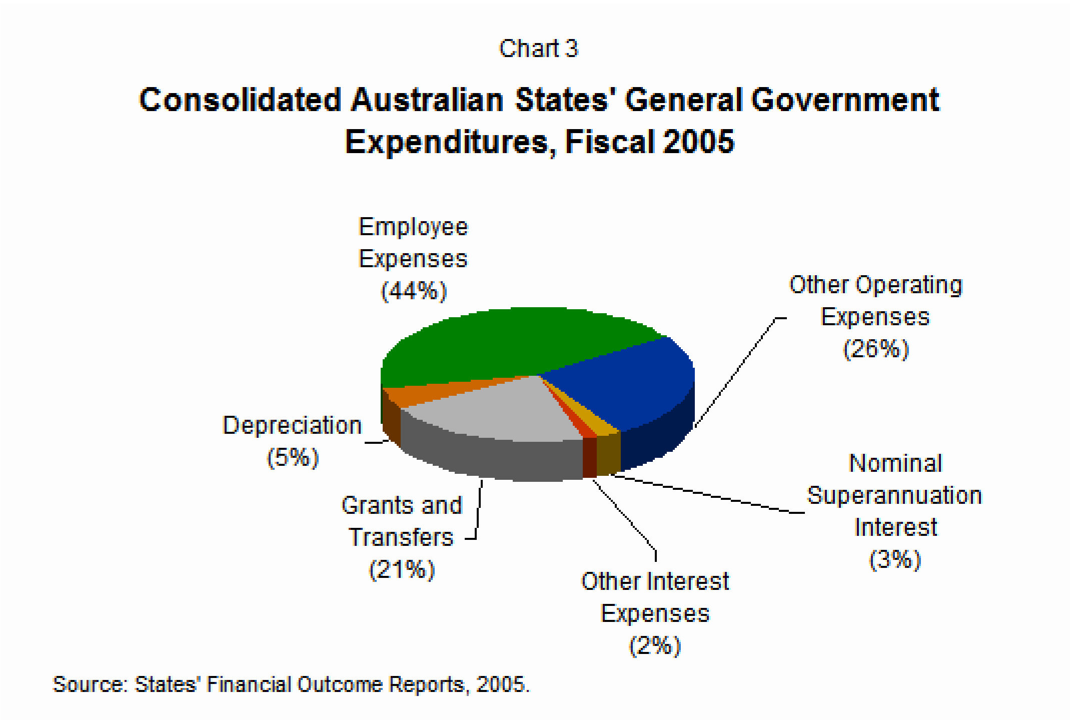
Chart 2



All states face cost pressures in the politically sensitive health, education, and justice sectors, limiting their expenditure flexibility. There are practical difficulties in controlling the volume of these services and the cost at which they are provided. In particular, the labour-intensive nature of these services introduces a degree of inflexibility to the state's spending.

For example, wages and employee-related expenses made up about $A53 billion, or 43% of general government expenses (see chart 3), a significant proportion of a state's expenditure base.

Chart 3



With all states facing a growing demand for services from an aging population, it is unlikely that health expenditure as a proportion of total expenditure will subside in the near future.

The Commonwealth can place conditions on its grants, which can further decrease states' expenditure flexibility by providing tied grants. For example, about 20% of Tasmania's general government total grants and subsidies are from Specific Purpose Grants (SPPs) from the Commonwealth (tied grants for purposes stipulated by the Commonwealth). SPPs provide an opportunity for the Commonwealth to implement a number of policy initiatives, potentially encroaching on state responsibility areas and limiting expenditure flexibility.

Despite these limitations to financial flexibility, the states do have some expenditure flexibility:

- The states' spending responsibilities are largely sheltered from economic cycles, and this is particularly so because they are not responsible for unemployment welfare payments. As such, a decrease in economic activity is not going to increase general government operating expenditures very much.
- Although strong economic activity can lead to increase operating expenditures through higher wage pressure, budget provisioning and staggered wage negotiations are widely used to manage this volatility.
- The states' actual revenues often exceed forecast revenues. This is largely the result of additional Commonwealth grants or budgeting conservatism. These windfalls can provide the states with some extra headroom and expenditure flexibility. Indeed, some unbudgeted spending only takes place in response to greater-than-expected revenue collection.

Capital Expenditure

There currently exists a political imperative for the states to meet additional infrastructure demands. Although Standard & Poor's is not convinced that there is an infrastructure crisis, there are pockets around the country that require investment. This political imperative limits the states expenditure flexibility (see Australian State Governments Likely To See Deficits As Infrastructure Spending Rises, RatingsDirect, April 28, 2005).

Most of the states have comfortable headroom for additional capital expenditure without jeopardising their credit rating. Indeed, all states are forecasting a rise in capital expenditure from fiscal 2005 levels (see chart 4).

Standard & Poor's is not concerned about moderate targeted capital spending, and indeed, would rather see funds channeled into capital projects than into higher operating expenses. This is because capital expenditure can be easily halted, if required, whereas pay increases or tax reductions, which increase a state's operating expenditure or lowers recurrent operating revenue, are difficult to reverse.

Chart 4

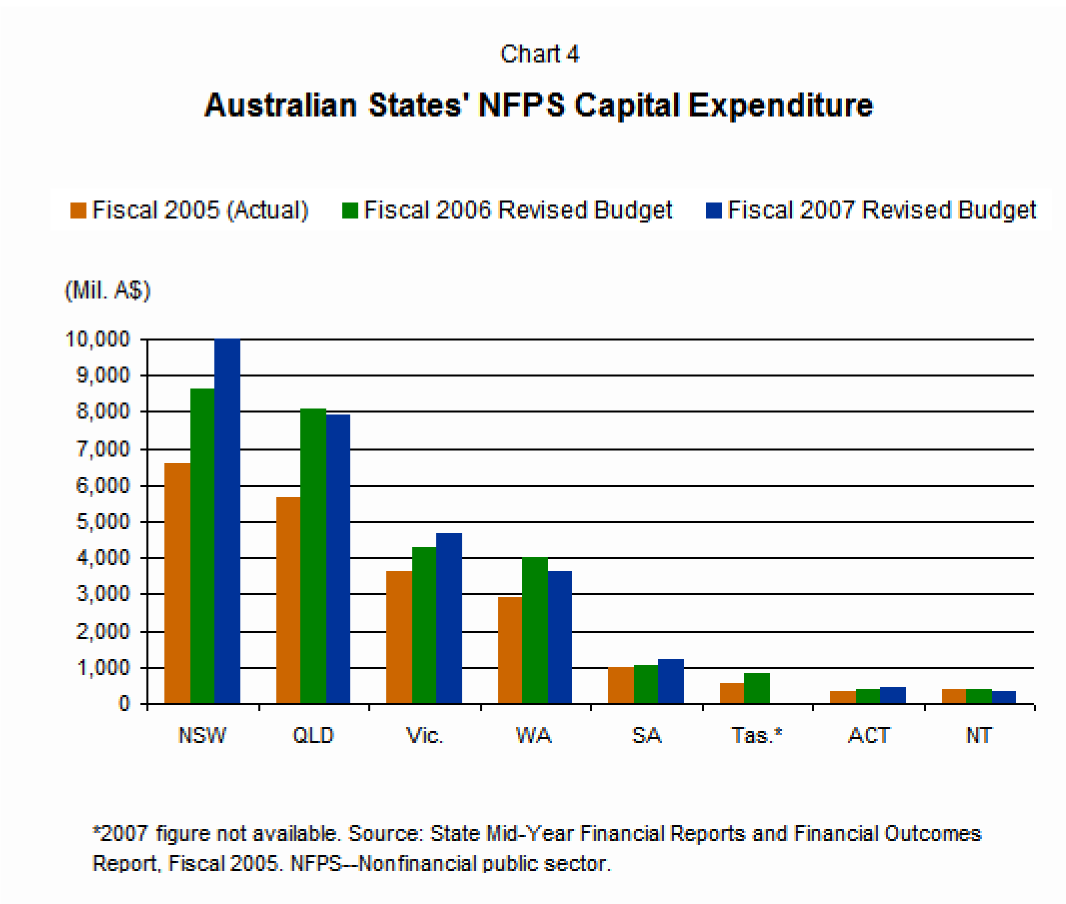


Table 1.

Australia's Commonwealth, and State and Territory Governments	
	Ratings
Australia (Commonwealth of)	AAA/Stable/A-1+

Table 1.

Australia's Commonwealth, and State and Territory Governments (cont.)	
New South Wales (State of)	AAA/Stable/A-1+
Victoria (State of)	AAA/Stable/A-1+
Queensland (State of)	AAA/Stable/A-1+
Western Australia (State of)	AAA/Stable/A-1+
Australian Capital Territory (Government of)	AAA/Stable/A-1+
South Australia (State of)	AAA/Stable/A-1+
Tasmania (State of)	AA+/Stable/A-1+
Northern Territory	Not Rated