TREASURY SUBMISSION TO SENATE COMMITTEE ON STATE GOVERNMENT FINANCES

This submission provides data on key fiscal indicators in recent years for the States and Territories (hereinafter referred to as States), together with an explanation of these indicators, to assist the Committee in its inquiry. This data is sourced from State budget documents and from ABS Government Finance Statistics data.

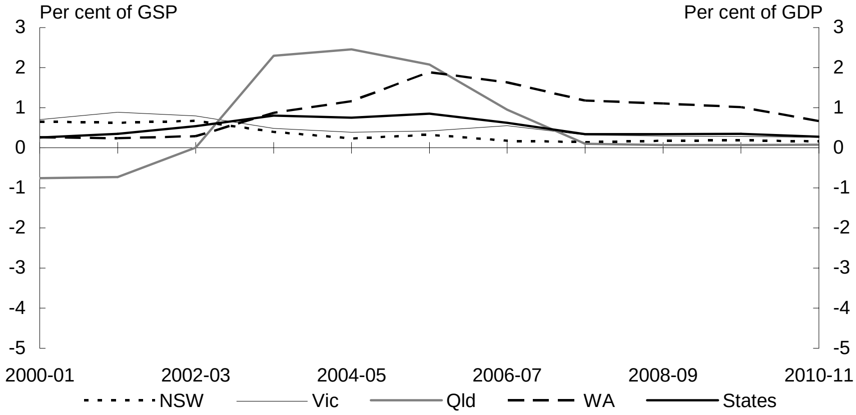
Treasury monitors fiscal conditions in the States in providing advice to the Treasurer and other Treasury Ministers on effective arrangements for Commonwealth-States financial relations and on domestic economic conditions. In undertaking this task, Treasury monitors a range of fiscal indicators for the States and Territories as no single indicator is suitable for all purposes and as a general summary indication of States fiscal conditions.

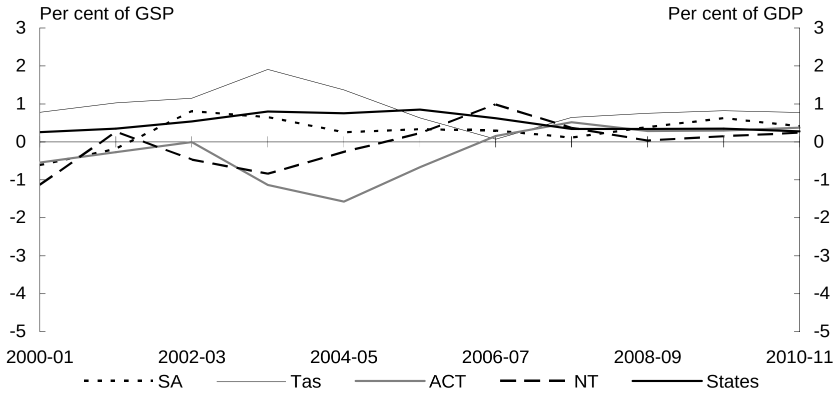
STATE GENERAL GOVERNMENT SECTOR NET OPERATING BALANCE

As shown in Chart 1, the States are expected to record net operating surpluses for the general government sector in 2007-08 and over the forward estimate period (2008-09 to 2010-11). The aggregate state general government sector net operating position is expected to be a small surplus in 2007-08, broadly in line with 2006-07 as a proportion of GDP. The fall in States' operating balances, compared with 2005-06, largely reflects the impact of higher expenditures and slower revenue growth.

The net operating balance measures, in accrual terms, the gap between a government's expenses and revenue for a given period. It provides a good indication of the sustainability of the existing level of government services. An operating surplus indicates that a government can finance the services it provides in a period using revenues derived in that period An operating deficit indicates that a government must borrow or sell assets in order to finance services provided in a period. The States as a whole are funding their current operations out of revenue. They are not borrowing, in a net sense, to fund their day to day operations.

Chart 1: Individual state general government sector net operating balance [(a)]





(a) States' net operating balances are expressed as a percentage of Gross State Product (GSP) (left hand axis) and the States' aggregate net operating balance is expressed as a percentage of Gross Domestic Product (GDP) (right hand axis).

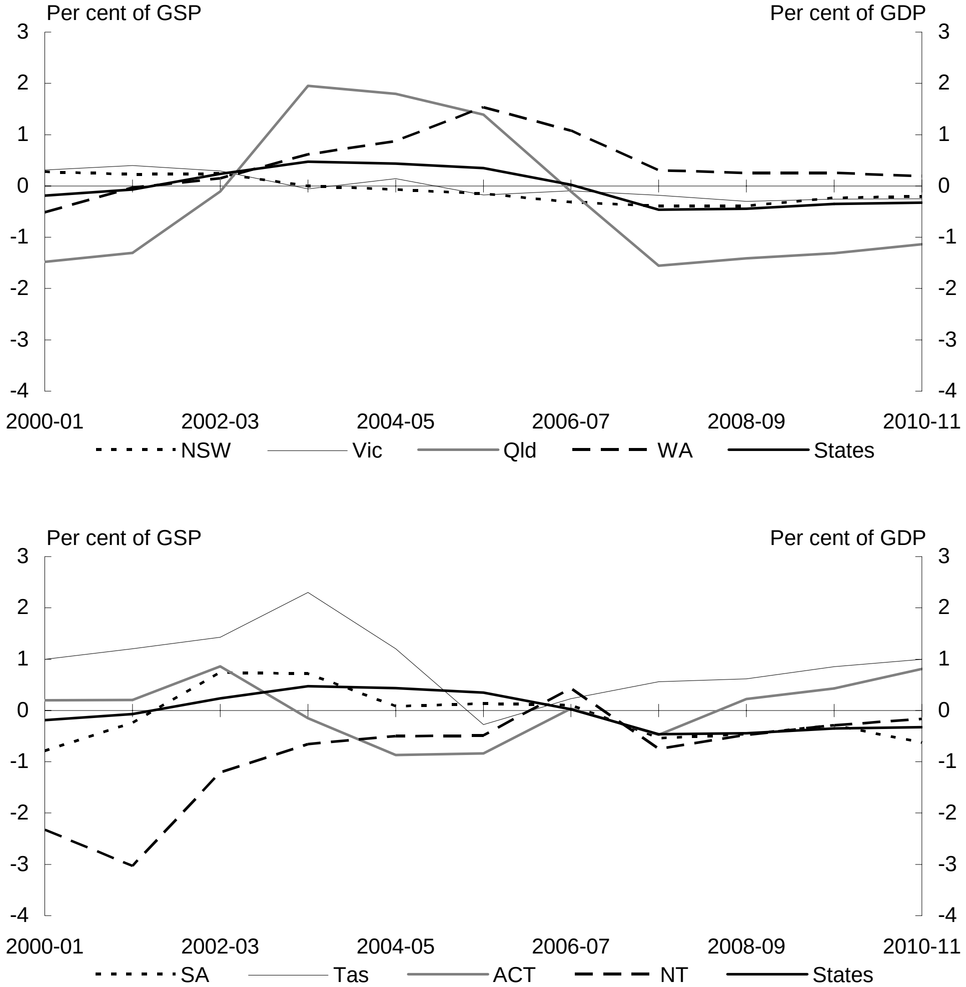
Sources: ABS cat. no. 5512.0, State 2007-08 mid-year reports.

STATE GENERAL GOVERNMENT SECTOR FISCAL BALANCE

The net operating balance does not include capital expenditures by general government. Rather, the fiscal balance indicator includes capital expenditure (capital expenditure is discussed in more detail in the Investment in Infrastructure section of this submission). As shown in Chart 2, most States expect to have fiscal deficits in 2007-08 and in the forward years. The aggregate state fiscal balance for the general government sector is estimated to be in deficit by 0.5 per cent of GDP in 2007-08 (Chart 2). Given that the aggregate state operating balance is expected to be a small surplus in 2007-08, the aggregate state fiscal deficit arises from the funding of capital expenditure. The aggregate fiscal balance is expected to be in deficit over the forward years. Western Australia is the only State expected to have a fiscal surplus in 2007-08 and in the forward years, reflecting its large operating surpluses, which are more than sufficient to cover its general government capital expenditures.

The fiscal balance measures, in accrual terms, the gap between government savings plus net capital transfers, and investment in non-financial assets. A fiscal deficit indicates that a government is a net borrower. A fiscal surplus indicates that a government is a net lender to other sectors.

Chart 2: Individual state general government sector fiscal balance (a)



(a) States' fiscal balances are expressed as a percentage of GSP (left hand axis) and the States' aggregate fiscal balance is expressed as a percentage of GDP (right hand axis).

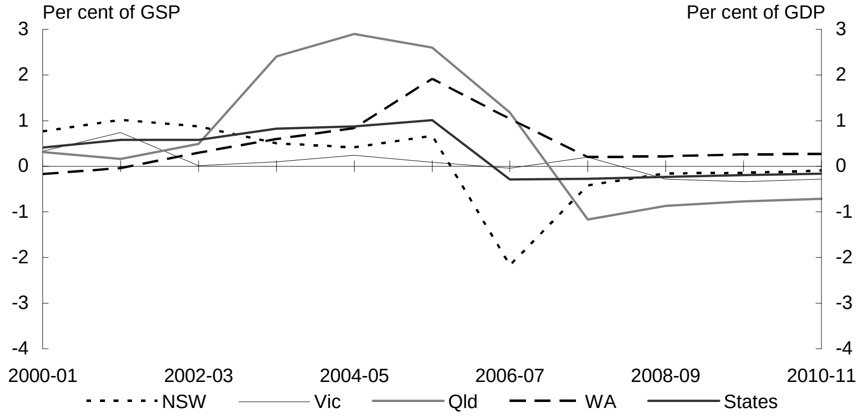
Sources: ABS cat. no. 5512.0, State 2007-08 mid-year reports.

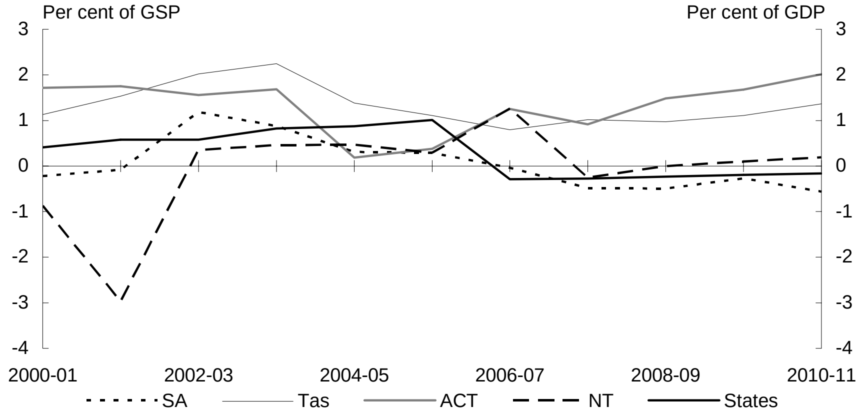
STATE GENERAL GOVERNMENT SECTOR CASH BALANCE

The fiscal balance indicator is an accrual measure, which means that it takes into account forward commitments by the general government sector, even before these commitments fall due. Accrual measures provide a more comprehensive picture than cash measures of the total activity of government and the long-term effects of current policy, thereby enhancing governments' fiscal transparency and accountability. The cash balance indicator measures commitments as they are due in the relevant period. That is, a principal difference between the fiscal balance indicator and the cash balance indicator is the timing of transactions.

As with the fiscal balance, most States expect to record cash deficits in 2007-08 (Chart 3), reflecting funding of capital expenditure. In aggregate, the general government sector cash position is expected to be a deficit of 0.3 per cent of GDP in 2007-08. The aggregate general government sector cash deficit is expected to continue over the forward years, reflecting the incidence of general government capital expenditures.

Chart 3: Individual state general government sector cash balance [(a)]





(a) States' cash balances are expressed as a percentage of GSP (left hand axis) and the States' aggregate cash balance is expressed as a percentage of GDP (right hand axis).

Sources: ABS cat. no. 5512.0, State 2007-08 mid-year reports.

A cash surplus reflects the extent to which cash is available to a government to increase financial assets or decrease liabilities (assuming no revaluations or other changes occur). A cash deficit measures the extent to which a government requires cash, either by running down financial assets or by borrowing.

The fiscal indicators of net operating balance, the fiscal balance and the cash balance are generally cited in commentaries on the fiscal sustainability of state governments.

STATE NET DEBT

Net debt is a common measure of the strength of a government's financial position. The higher the net debt of a government, the greater the call that will be imposed on the government's future revenue flows to service that debt. The level of general government net debt and the capacity of governments to service this debt are important indicators of the overall financial health of a jurisdiction. These factors affect the flexibility of governments to adjust fiscal policy to respond to change in economic and financial circumstances.

Net debt is the sum of selected financial liabilities (deposits held, advances received, government securities, loans and other borrowing) less the sum of selected financial assets (cash and deposits, advances paid, and investments, loans and placements).

The focus of net debt is on shorter-term liabilities and more fluid assets, so it does not include some substantial claims of a more medium to long term nature (such as superannuation-related liabilities).

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 Commonwealth Government is committed to issuing sufficient Treasury Bonds to support the Treasury Bond Futures market, despite having large cash surpluses to fund spending.

Borrowing to fund economically viable infrastructure spending does not necessarily reflect poor economic management. In fact, it can help to spread the burden of paying for that infrastructure amongst those generations that benefit from it. Infrastructure can expand the nation's productive capacity thereby allowing it to achieve sustainable strong growth at low inflation.

Net debt does not measure the net worth of a government (i.e. the market value of a government's assets and liabilities) because it does not include non-financial assets (buildings, land, plant and equipment). In particular, an increase in the net debt of a government caused by the acquisition of non-financial assets need not reduce the net worth of a government, and may increase its net worth if the financial rate of return on the non-financial assets exceeds the rate of interest on the funds borrowed to finance their acquisition. Net worth is discussed in more detail below.

Differences in net debt among governments will partly reflect differences in the extent to which each government has chosen to hold financial assets vis-à-vis non-financial assets.

Most States are forecasting an increase in general government sector net debt in 2007-08 and in the forward years as they borrow to finance significant capital expenditure programmes (Chart 5). However, Queensland, Western Australia, Tasmania and the Australian Capital Territory expect to have a net debt position below zero in 2007-08 and the forward years (i.e. short term assets are expected to exceed liabilities).

In aggregate, the state general government sector continues to record net debt levels below zero. Its net debt is expected to be -2.0 per cent of GDP in 2007-08, falling to -0.9 per cent of GDP by 2010-11.

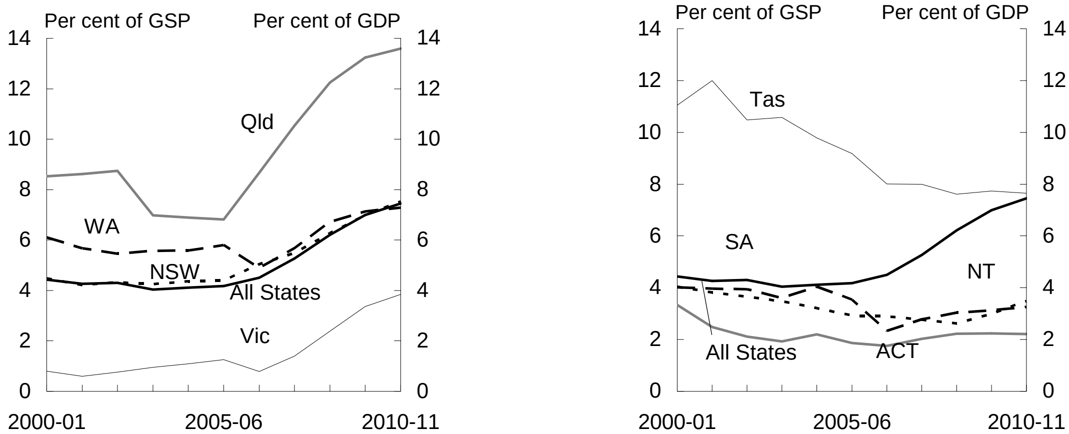
It is also useful to monitor net debt for the aggregate state public non-financial corporations sector because this sector owns nearly all of the stock of state public debt. It is estimated to be 4.5 per cent of GDP in 2006-07, up from 4.2 per cent in 2005-06.

In aggregate, net debt of the state total non-financial public sector (which combines general government and public non-financial corporations) is expected to be $37,148 million (3.3 per cent of GDP) in 2007-08. It is expected to increase to $86,265 (6.6 per cent of GDP) in 2010-11.

Chart 4: Individual state net debt by sector (as at end of financial year) [(a)]

General government

Public non-financial corporations



Non-financial public sector

(a) States' net debt is expressed as a percentage of GSP (left hand axis) and the States' aggregate net debt is expressed as a percentage of GDP (right hand axis).

Sources: ABS cat. no. 5512.0, State 2007-08 mid-year reports.

Debt servicing

An estimate of State interest payments, compiled from State data, is presented below. Interest payments are expected to increase slightly over the forward estimates as States fund their infrastructure programmes. However, these payments remain a small percentage of the States' revenue.

Table 1: General government sector – other interest expenses

	1998-99	1999-00	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11
NSW	1,362	1,343	1,016	868	806	788	819	1,183	1,218	1,309	1,395	1,507	1,596
Vic	666	522	551	519	548	537	426	452	459	489	554	660	777
Qld	154	283	338	223	220	211	207	173	179	402	650	928	1,106
WA	252	236	240	214	195	165	155	120	112	113	130	137	142
SA	643	601	353	272	297	253	248	223	204	226	255	286	315
Tas	189	157	122	89	80	67	49	27	23	16	14	16	15
ACT	58	49	75	58	58	54	54	59	60	57	58	61	63
NT	128	141	145	151	144	144	129	117	139	142	141	141	143
States	3,451	3,332	2,839	2,394	2,349	2,219	2,087	2,353	2,394	2,753	3,197	3,736	4,157

Table 2: General government interest payments as a percentage of total revenue

	1998-99	1999-00	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11
NSW	4.5	4.2	3.0	2.4	2.1	2.0	2.0	2.7	2.6	2.7	2.8	2.9	2.9
Vic	2.9	2.3	2.3	2.0	2.0	1.9	1.4	1.4	1.3	1.4	1.5	1.7	1.9
Qld	0.9	1.6	1.9	1.2	1.1	0.8	0.7	0.6	0.6	1.2	1.9	2.6	3.0
WA	2.8	2.4	2.3	1.9	1.7	1.3	1.1	0.7	0.6	0.6	0.7	0.7	0.7
SA	8.8	7.9	4.4	3.2	3.2	2.5	2.3	2.0	1.7	1.8	2.0	2.1	2.3
Tas	7.8	6.0	4.5	3.1	2.7	2.1	1.5	0.8	0.6	0.4	0.3	0.4	0.4
ACT	3.7	2.7	3.6	2.7	2.5	2.3	2.3	2.2	2.1	1.8	1.8	1.8	1.8
NT	6.7	7.4	6.5	6.5	6.1	5.6	4.8	3.9	4.2	4.0	3.9	3.9	3.8
States	3.8	3.5	2.8	2.2	2.1	1.8	1.6	1.7	1.6	1.7	1.9	2.2	2.3

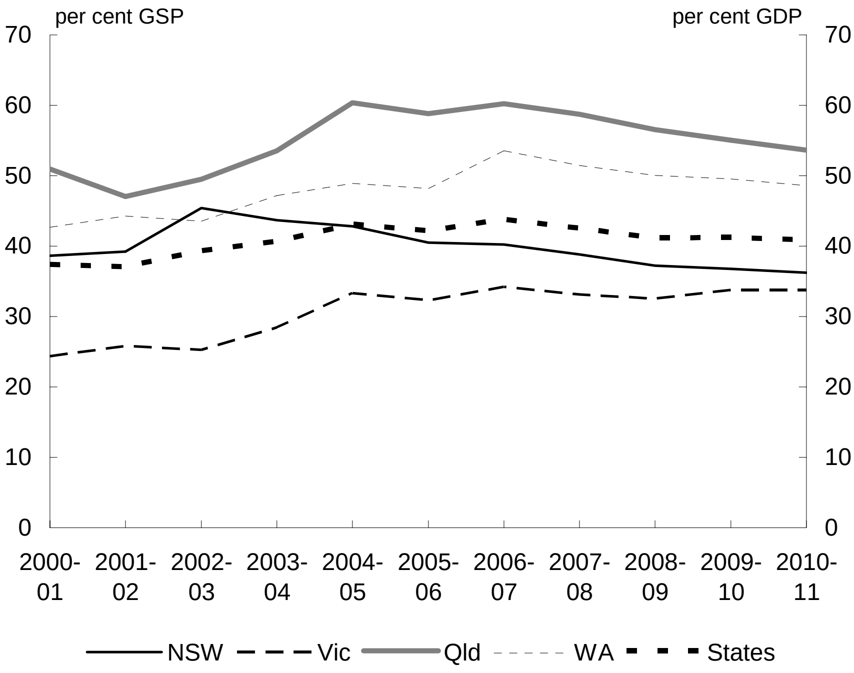
Note: Data is presented on an accrual basis. In the past, the Commonwealth's preferred display basis has been cash, thus the numbers presented in recent Australian Government budget papers are not comparable with these numbers.

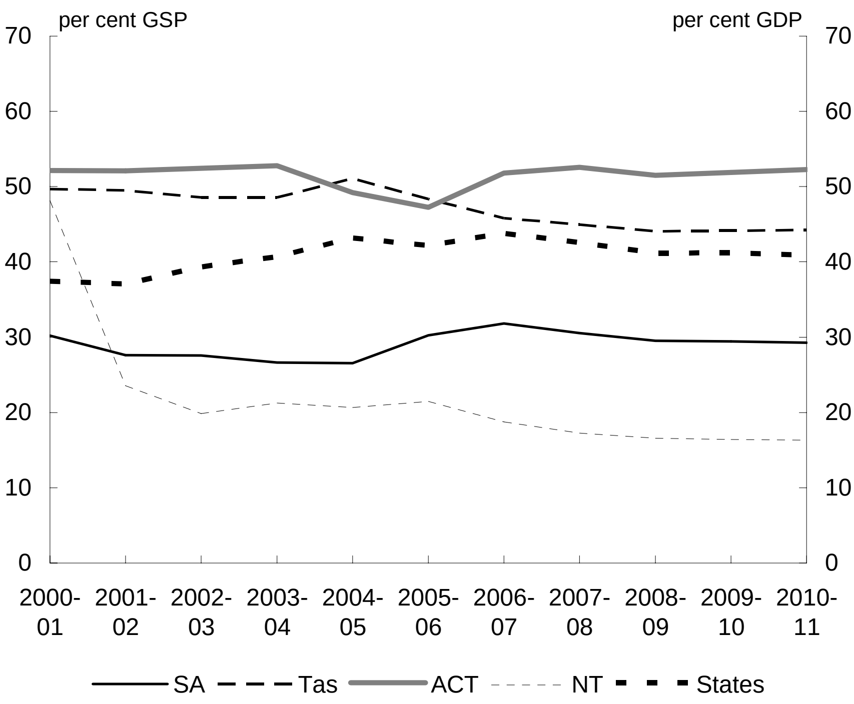
NET WORTH

Net worth is another useful indicator of the efficiency of the public sector. Net worth is the broadest available measure of liabilities and includes all assets (including non-financial assets) less all liabilities (but excludes shares and contributed capital). However, the net worth measure is not without limitations. The ability to value reliably government assets (such as national parks and government buildings) is an issue. Also, a government may not necessarily be in a position to sell non-financial assets on its balance sheet to meet liabilities (e.g. for policy reasons), or might find that to do so may involve selling at prices below the balance sheet valuation.

The state general government sector is estimated to have a positive net worth of 42.5 per cent of GDP in 2007-08. State net worth has increased in nominal terms each year since 1998-99, but has increased only marginally as a proportion of GDP.

Chart 5: State general government net worth as a percentage of GSP/GDP





Sources: ABS GFS data, State budget papers, Treasury.

COMMONWEALTH FUNDING OF THE STATES

A significant source of funding for the States is derived from the Commonwealth. This flow of funding obviously affects State budgetary and fiscal positions. The following sections detail the flow of funding from the Commonwealth to the States in the form of GST revenue payments, other general revenue payments and Specific Purpose Payments (SPPs).

Total Payments

Total Commonwealth funding payments to the States for 2007-08 (comprising GST revenue, general revenue assistance and SPPs) is expected to be $73.1 billion.

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 previous financial arrangements continued.

The Commonwealth provided SPPs totalling $30.3 billion in 2007-08, and is estimated to provide $30.9 billion in 2008-09.

The Commonwealth provided $22.6 billion in SPPs ‘to’ the States and $7.6 billion in payments ‘through’ the States in 2007-09. In 2008-09, SPPs ‘to’ the States are estimated to be $22.8 billion and payments ‘through’ the States to be $8.1 billion. Payments ‘to’ the States are payments to State governments for them to use in support of state service delivery responsibilities. Payments ‘through’ the States are payments to State governments to be passed on to local governments and others, such as non government schools and financial assistance grants to local government.

Table 3: Total Commonwealth funding from 2000-01 to 2010-11[(a)]

($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

(a) Mid-year economic and fiscal outlook 2007-08 estimates.

Table 4: Commonwealth funding to the States in 2007-08[(a)]

($million)	NSW	VIC	QLD	WA	SA	TAS	ACT	NT	Total
GST revenue	11,928.2	9,244.6	8,517.2	3,963.1	3,904.3	1,655.5	842.7	2,174.4	42,230.0
SPPs "to" the States	7,274.1	4,948.1	4,468.8	2,878.1	1,760.6	555.4	321.3	402.3	22,618.7
SPPs "through" the States	2,451.7	1,909.9	1,481.0	778.4	598.3	191.5	154.2	79.6	7,644.5
SPPs direct to local government	172.8	123.4	128.7	83.8	39.5	25.9	0.0	13.7	587.8
Other payments									
National Competition Policy Payments	26.3	9.9	-	4.0	3.0	-	-	-	43.2
Total payments	21,853.1	16,235.8	14,595.6	7,707.4	6,305.7	2,428.3	1,318.3	2,670.0	73,124.1

(a) Mid-year economic and fiscal outlook 2007-08 estimates.

Budget balancing assistance (BBA)

As part of the introduction of the GST, the Commonwealth guaranteed that the budgetary position of each State would be no worse than it would have been had the reforms not been implemented. The guaranteed minimum amount (GMA) is an estimate of the revenue that each State would have received under the previous system of financial assistance grants and if some of the States’ own taxes had not been abolished as part of the reforms. Where, during the transitional period (which will expire on 30 June 2009), a State’s GST receipts in a financial year are less than its GMA, the

Commonwealth is liable to pay that State budget balancing assistance (BBA) so that that State is no worse off.

The last time BBA was paid was in 2003-04 to New South Wales. In 2007-08 and the forward years, all States are expected to receive more GST revenue than their GMA. Consequently, no State will require BBA.

Other payments

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. In 2005-06, the Commonwealth suspended some payments, due to a lack of progress and outstanding reforms with respect to water planning.

On 13 September 2007, these suspensions were lifted following a recommendation by the National Water Commission that there had been satisfactory progress by the States in implementing their water reform commitments. Consequently, suspended payments of $43.2 million were paid in 2007-08. These payments are the final payments under the National Competition Policy arrangements.

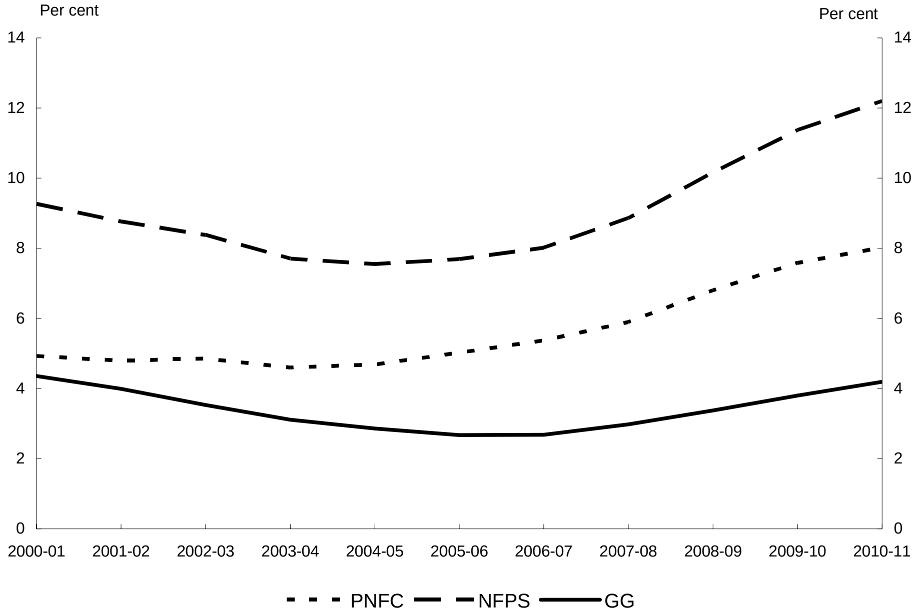
The Commonwealth also provides compensation to the States for the deferral of GST revenue resulting from its decision that small businesses and non-profit organisations, which voluntarily registered for the GST, could pay and report GST on an annual, rather than monthly or quarterly, basis. Due to an overpayment of this compensation to the States, the Commonwealth agreed with the States to suspend the payments for 2006-07.

Special revenue assistance was paid to the Australian Capital Territory in 2000-01 and 2001-02 in accordance with recommendations of the Commonwealth Grants Commission.

BORROWING LEVELS OF STATE GOVERNMENTS

The level of borrowing engaged in by State government and public sector entities can be measured in different ways. For the purposes of this submission, we have focused on the balance sheet item ‘Borrowing’. This item reports solely on the borrowings of the various government sectors and is one component of the calculation for net debt. ‘Borrowing’ in this context is defined as: liabilities, other than advances, created through direct agreements with lenders, the sale of securities and acquisition of finance leases. It should also be noted that this measure of borrowings does not give the full picture of a State’s debt position as it ignores superannuation liabilities, as well as the assets States hold to assist in meeting those future liabilities.

Chart 6: Aggregate state borrowing as a percentage of GDP



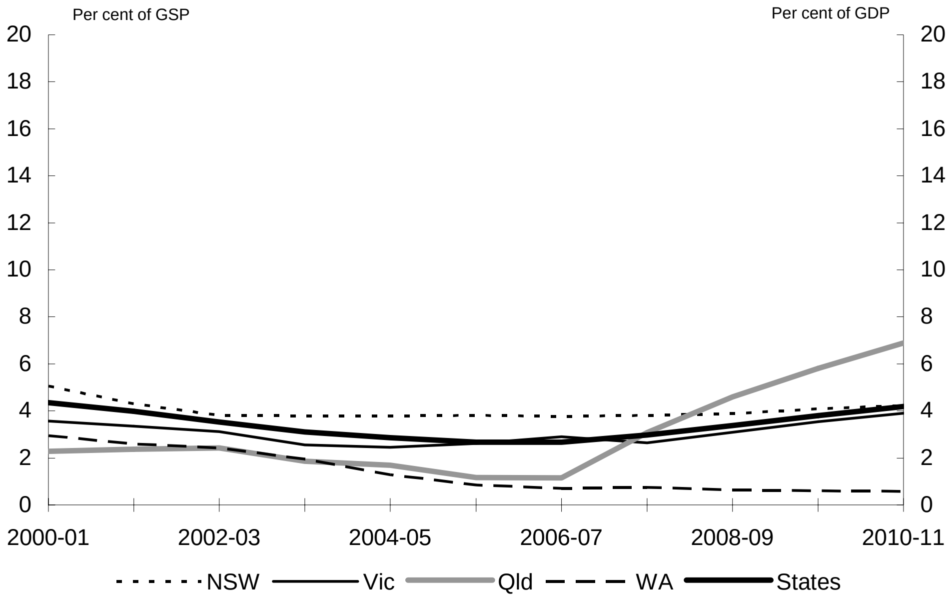
Sources: ABS GFS data, State budget papers, Treasury.

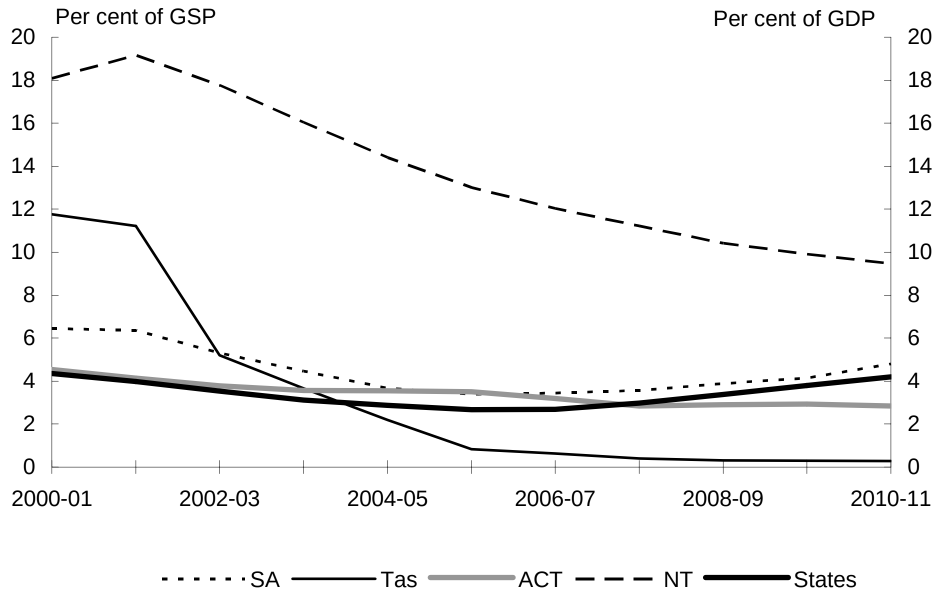
Table 5: General government borrowing as a percentage of GSP/GDP

	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	3.77	3.82	3.89	4.09	4.23
Vic	3.57	3.36	3.12	2.56	2.45	2.61	2.91	2.65	3.09	3.54	3.90
Qld	2.28	2.37	2.43	1.87	1.69	1.17	1.16	3.08	4.60	5.81	6.89
WA	2.96	2.60	2.43	1.95	1.28	0.85	0.70	0.76	0.63	0.61	0.58
SA	6.45	6.36	5.31	4.47	3.68	3.39	3.44	3.57	3.89	4.14	4.81
Tas	11.76	11.23	5.19	3.66	2.19	0.83	0.64	0.40	0.30	0.29	0.28
ACT	4.54	4.14	3.78	3.56	3.54	3.50	3.19	2.84	2.90	2.93	2.84
NT	18.08	19.16	17.76	16.03	14.39	13.02	12.04	11.22	10.42	9.91	9.46
States	4.35	3.99	3.53	3.11	2.87	2.68	2.68	2.98	3.38	3.80	4.19

Sources: ABS GFS data, State budget papers, Treasury.

Chart 7: General government borrowings





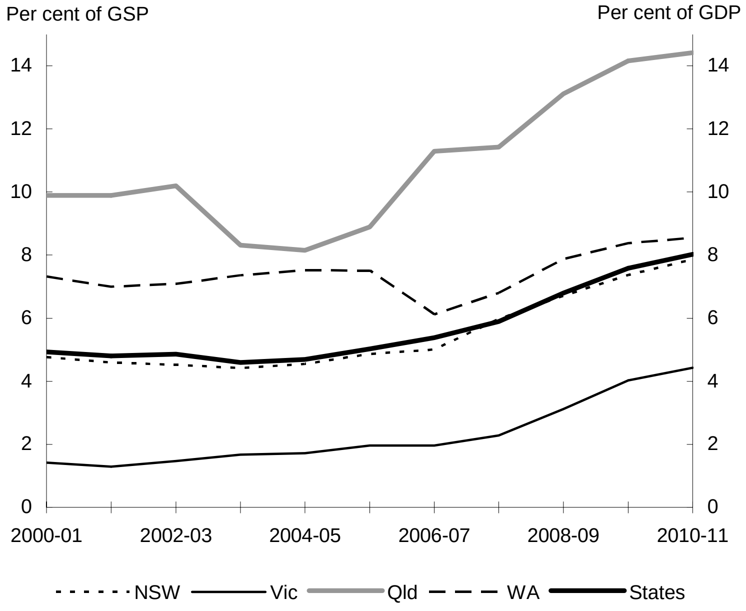
Sources: ABS GFS data, State budget papers, Treasury.

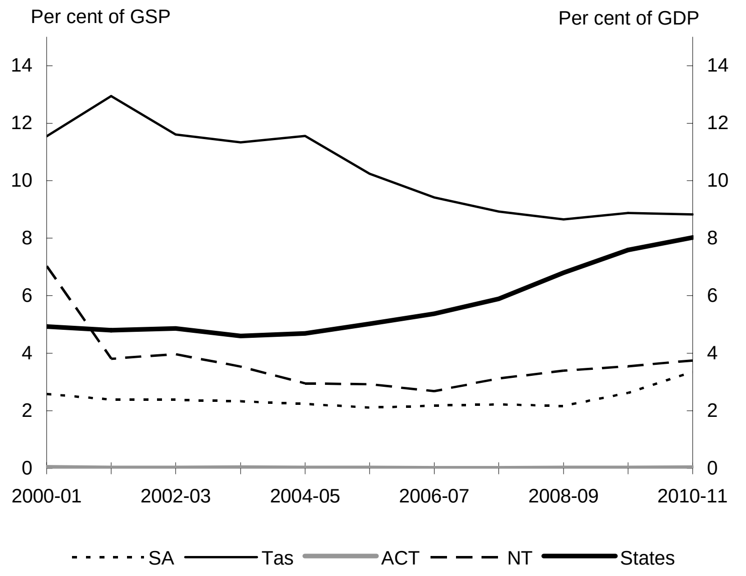
Table 6: Public non-financial corporations borrowing as a percentage of GSP/GDP

	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	5.01	5.97	6.71	7.37	7.86
Vic	1.42	1.29	1.47	1.67	1.72	1.96	1.96	2.28	3.12	4.03	4.43
Qld	9.89	9.90	10.20	8.31	8.16	8.90	11.29	11.42	13.12	14.16	14.43
WA	7.33	7.00	7.09	7.36	7.52	7.51	6.11	6.79	7.87	8.38	8.54
SA	2.58	2.39	2.38	2.33	2.24	2.11	2.18	2.22	2.17	2.62	3.36
Tas	11.55	12.94	11.60	11.34	11.56	10.24	9.41	8.93	8.65	8.88	8.82
ACT	0.03	0.01	0.01	0.02	0.01	0.01	0.00	0.00	0.01	0.01	0.02
NT	7.02	3.81	3.96	3.53	2.95	2.92	2.68	3.12	3.39	3.55	3.75
States	4.93	4.80	4.86	4.60	4.68	5.02	5.38	5.90	6.80	7.59	8.02

Sources: ABS GFS data, State budget papers, Treasury.

Chart 8: Public non-financial corporations borrowing





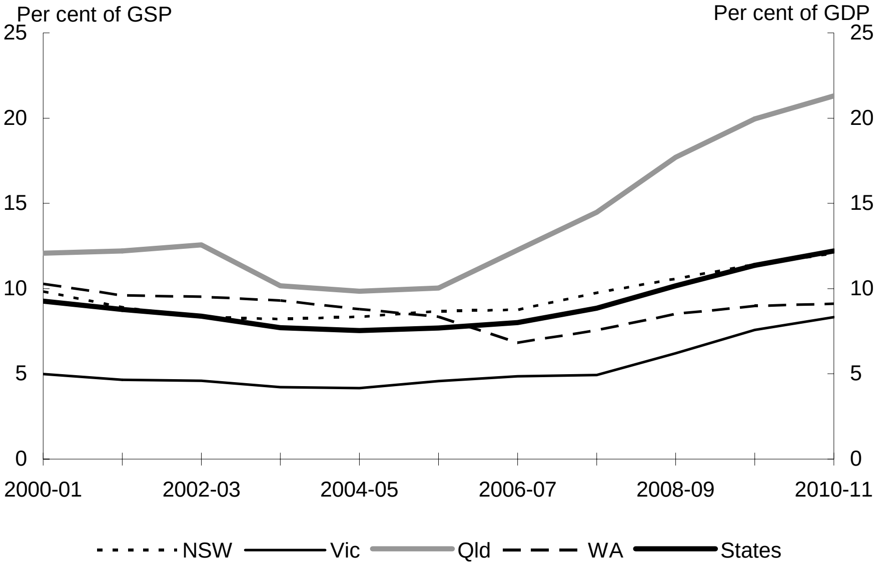
Sources: ABS GFS data, State budget papers, Treasury.

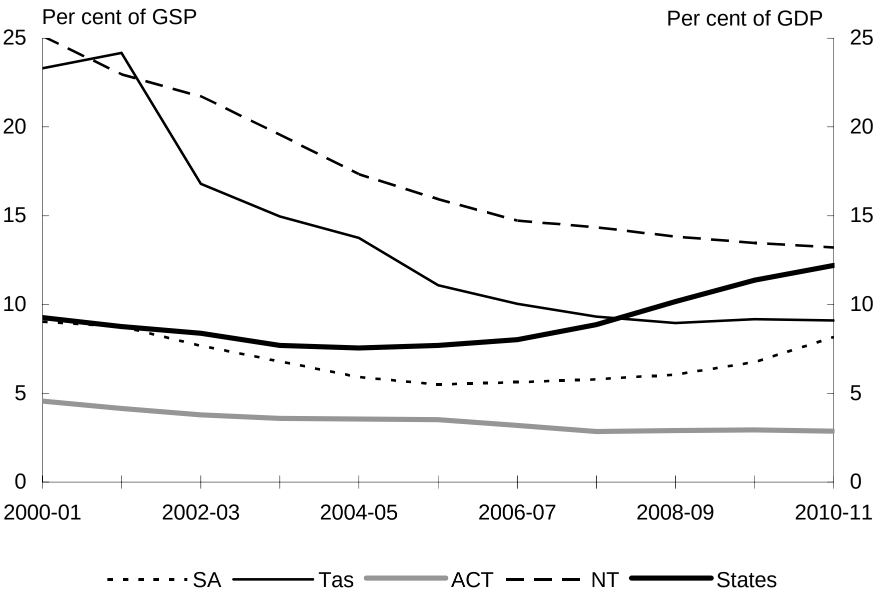
Table 7: Non-financial public sector borrowings as a percentage of GSP/GDP

	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	8.76	9.76	10.57	11.42	12.06
Vic	4.99	4.65	4.59	4.23	4.17	4.57	4.86	4.92	6.21	7.57	8.32
Qld	12.08	12.21	12.56	10.17	9.84	10.04	12.27	14.49	17.70	19.96	21.31
WA	10.28	9.60	9.52	9.31	8.80	8.35	6.82	7.55	8.51	8.99	9.12
SA	9.03	8.76	7.68	6.80	5.91	5.50	5.62	5.79	6.06	6.77	8.16
Tas	23.30	24.16	16.80	14.96	13.75	11.08	10.05	9.33	8.96	9.17	9.10
ACT	4.57	4.15	3.79	3.58	3.55	3.51	3.19	2.84	2.91	2.94	2.86
NT	25.10	22.97	21.73	19.56	17.35	15.94	14.72	14.35	13.82	13.46	13.21
States	9.27	8.77	8.38	7.71	7.55	7.69	8.01	8.86	10.17	11.37	12.20

Sources: ABS GFS data, State budget papers, Treasury.

Chart 9: Non-financial public sector borrowings





Sources: ABS GFS data, State budget papers, Treasury.

The Committee's terms of reference also indicate an interest in why the public sector borrows. At the most basic level, the public sector (and particularly the public non-financial corporations sector) borrows to fund major projects that it may not be able to afford out of general revenues. For the public non-financial corporations sector, investment also needs to be justified against the expected increase in future revenue streams. This is no different from any major company borrowing to fund new revenue raising infrastructure or other ventures, providing it is a market driven decision. Borrowing also allows the costs of major projects to be, in part, borne by future generations who will also derive a benefit from them.

Open and liquid capital markets mean that these borrowings should not have a material impact on the general availability of funds to private investors, but other investors may, of course, be constrained if the expenditure on infrastructure investment forces up the price of labour and capital.

INVESTMENT IN INFRASTRUCTURE

Chart 10 provides an overview of state capital investment (Gross Fixed Capital Formation – defined as purchases less sales of fixed assets).

Improvements in productivity can arise from a number of factors including investment in capital and labour, and technological advancement.

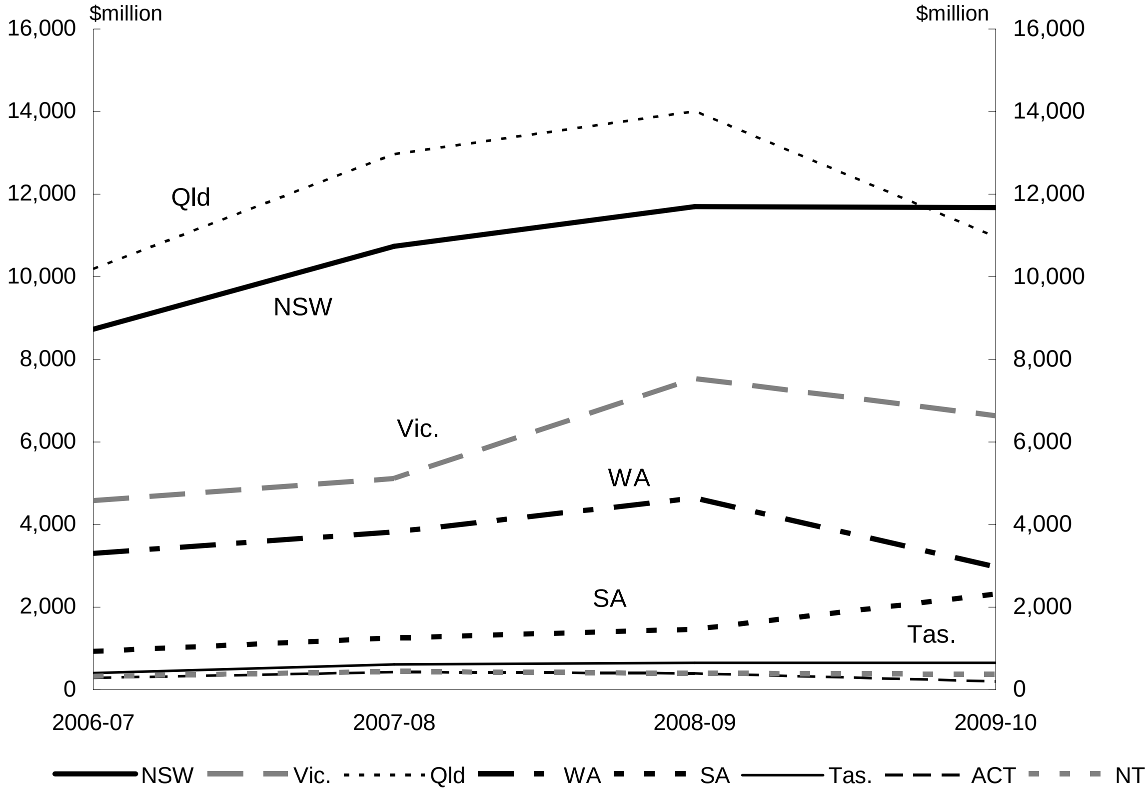
Infrastructure is capital and a means for the delivery of goods and services that promote prosperity, growth and wellbeing. Infrastructure is an essential input to virtually all economic activities. Ensuring that infrastructure is optimal in aggregate, allocated to the right areas and is used effectively, will reduce economic costs and contributes to more efficient production.

Australia is particularly dependent on efficient infrastructure and investment due to its size and population dispersion (road, rail, airports and communications), its climate (water and electricity) and its reliance on trade (ports).

In 2005 the Productivity Commission estimated that infrastructure sector reforms up to 2005 had increased Australia's GDP by 2.5 per cent. In 2005 the Export and Infrastructure Taskforce, chaired by Dr Brian Fisher, reported that there were immediate export infrastructure constraints caused by Australia's role in supplying the global commodities boom, but that these were localised in nature.

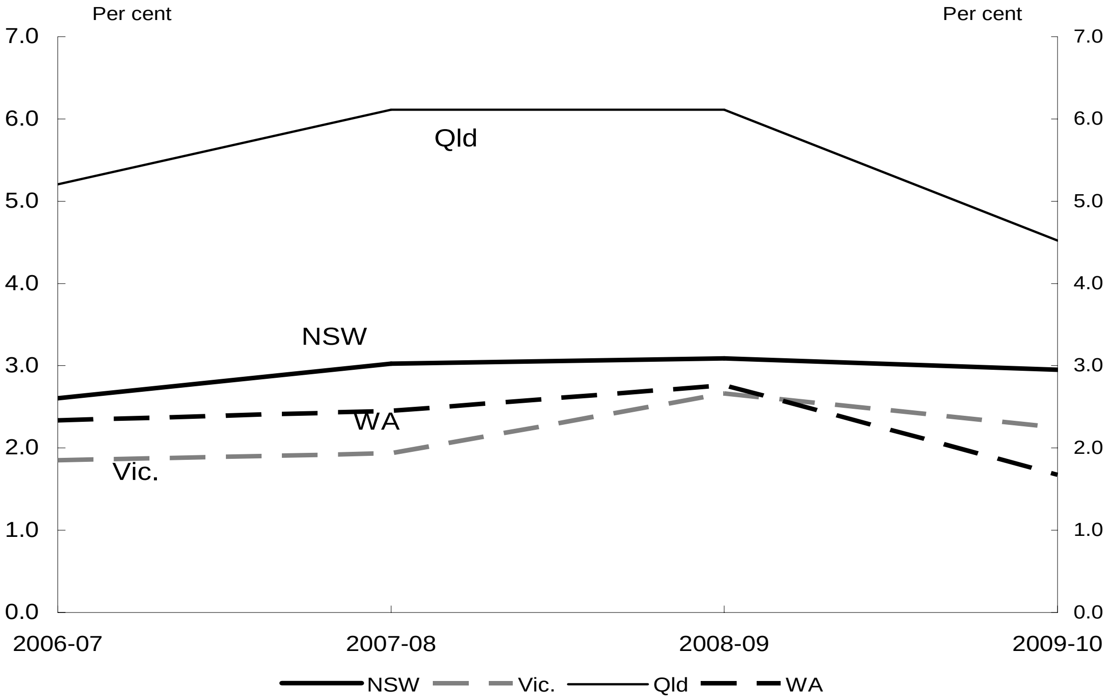
The OECD's 2006 *Economic Survey of Australia* found that, while infrastructure market reforms undertaken under the National Competition Policy (NCP) were largely a success, there remains "unfinished business" to raise productivity and reduce bottlenecks in all sectors, but most pressingly in water markets, where little progress has been made to date.

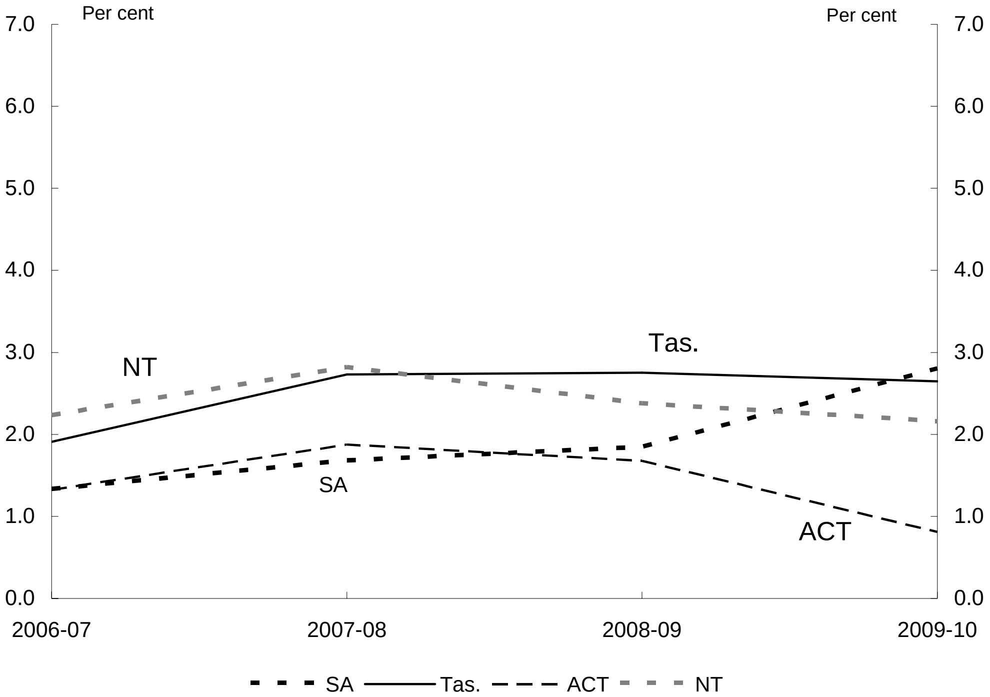
Chart 10: States' gross fixed capital formation



Sources: ABS GFS data, State budget papers, Treasury.

Chart 11: Gross fixed capital formation as a percentage of each State's GSP





Sources: ABS GFS data, State budget papers, Treasury.

IMPACTS OF DIVIDEND PAYMENTS

Treasury is not able to provide any indication of the impact of dividend payments from the public non-financial corporation sector on their ability to invest. Treasury does not have any data to substantiate or dismiss concerns that the payment of dividends to States may compromise the ability of public corporations to invest in infrastructure. Judgements of this nature require an understanding about the most appropriate use of funds by a particular public trading entity at a particular point in time. They would also require some benchmarks of what is an adequate level of infrastructure investment and appropriate rates of return on investment in different infrastructure sectors.

On the broader issue of dividend payments from the sector, it should be noted that the payment of dividends to state governments is analogous to the payment of dividends to shareholders in private companies. That is, the payment of dividends merely emulates a common method of return of profits to the investor. It is desirable that public corporations act competitively. Accordingly, the making of a market return on the provision of goods and services is desirable, and a return on the investment incurred by state governments for the provision of goods or service is not, in itself, undesirable. Indeed, a policy of retaining all normal profits in a public corporation would be questionable.

OWNERSHIP STRUCTURES IN THE PNFC SECTOR

Government business enterprises (GBEs) are involved in the production and the provision of goods and services and are substantial providers of infrastructure. GBEs operate across a range of sectors including energy (electricity and gas), water, urban transport, roads and railways.

Public ownership of assets and enterprises is more likely to deliver net benefits for the community if they exhibit significant public good, externality or natural monopoly characteristics. Government ownership may also be based on social objectives that cannot be achieved readily by other means (for example, the provision of subsidies to targeted community groups). In this regard, governments may require their GBEs to engage in business activities for non-commercial reasons, otherwise known as ‘Community Service Obligations’ (CSOs).

GBEs may take a range of organisational structures, which can be grouped into corporate and non-corporate forms. Corporatised GBEs may be established by statute or incorporated under the Corporations Act (Commonwealth). Corporatised GBEs operate on a basis which is as similar in terms of its objectives, incentives and sanctions to a private firm as is feasible while retaining the enterprise in government ownership.[1] Non-corporatised GBEs include statutory bodies, government departments or business units within a government department.

Different organisational forms of GBEs have varying accountability and governance arrangements, and typically are subject to differences in Ministerial direction.

- For corporatised GBEs that are established by statute, governance arrangements may be provided by legislation at the respective State or Commonwealth level (for example, the Commonwealth Authorities and Companies Act) or may include more specific legislation. Corporations Act GBEs are subject to the governance requirements of that Act.

- While all GBEs can be subject to the Ministerial direction, generally legislation will limit the type of directions Ministers can give to corporatised GBEs.

The organisational structure of a GBE (as per other organisations) contributes to its operational effectiveness and efficiency, including investment decisions and capacity[2]. The organisational structure of firms including GBEs is influenced by market conditions; and for GBEs, by whether they operate on a competitively neutral basis and in a competitive market with the private sector. In the absence of a competitive market environment, economic regulation may perform a similar role in shaping the performance of the GBE.

National Competition Policy

Reforms as part of National Competition Policy (NCP) have seen Commonwealth and State GBEs operating on a competitively neutral basis with private-sector firms, and a requirement for GBEs to be corporatised ‘where appropriate’ — thereby applying private sector firm characteristics to the GBE.

Competitive neutrality principles dictate that GBEs should operate on a commercial basis including earning commercial returns, setting financial targets, paying tax or tax equivalent payments, paying dividends and being subject to the regulation that applies to private firms. Competitive neutrality under NCP does not require governments to reduce their CSOs but failure by a government to

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[1] *National Competition Policy*, Report by the Independent Committee of Inquiry 1993 (Hilmer Report)

[2] The investment capacity of a GBE may also be affected by other factors such as markets conferring borrowing cost advantages on GBEs as a result of explicit government guarantees and perceptions of implicit government support. In such instances, debt neutrality is achieved by subjecting GBEs to similar borrowing costs to those faced by private sector businesses. For Commonwealth GBEs, where borrowing from private financial markets, a debt neutrality charge is set by the shareholder minister(s) based on stand-alone credit rating advice. For State GBEs, State Treasury Corporations borrow on behalf of the GBE and apply a debt neutrality charge.

appropriately cost and fund its CSOs will affect a GBE's ability to operative in a competitively neutral way.

In its final NCP assessments in 2005[3], the National Competition Council (NCC) assessed the states and territories as having met their obligations with respect to the structural reform of public monopolies and their explicitly stated objectives with regard to achieving competitive neutrality. However, the NCC noted there was scope still for improving the coverage of competitive neutrality principles and strengthening corporatisation models.

Failure of a GBE to operate on a competitively neutral basis may distort demand and resource allocation over time. Given that GBEs play a significant role in the provision of infrastructure services, it is important that resources are allocated to and used by GBEs on an efficient basis.

The Productivity Commission[4] has found that many GBEs are still not operating on a fully commercial basis and speculated that that this may be related to governance shortcomings, including:

- governments are not prepared to fully fund CSOs;
- prices are set below the level required to make a commercial rate of return:
  - regulators have used assumptions that differ from those underlying the GBE's operating circumstances or that are in error;
  - governments have written down assets or issued directives to boards to set low prices because there are externalities and other economic benefits that the government wishes to generate; and
- prices are reflective of efficient costs but the GBE is operating inefficiently.

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[3] National Competition Council, *Assessment of governments' progress in implementing the National Competition Policy and related reforms: 2005*

[4] Productivity Commission, research paper *Financial Performance of Government Trading Enterprises 2004-05 to 2005-06*