Submission to Select Committee on State Government Financial Management

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Introduction

This submission considers two aspects of Commonwealth–state fiscal management. First, the issue of state debt is considered. In particular the issue of state owned enterprises accumulating debt and paying dividends to state governments. Second, the issue of fiscal federalism is considered. It is not possible to review or reform state finances without also reviewing and reforming the tax system. Our views on these two issues are as follows:

- The states have accumulated debt in their commercial subsidiaries
- It is possible that this could contribute to some macroeconomic dislocation
- Given the massive surpluses of the Commonwealth government over the past decade, it is unlikely that state debt has contributed to any macroeconomic problems that Australia is currently experiencing
- The Commonwealth should exit the financing and/or provision of redistributive public goods
- The Commonwealth should give up all personal income tax powers and allow the states and territories to levy their own personal income tax.

1. State debt and dividends

1.1 When should government borrow?

Following James M. Buchanan we argue that government should only ever use debt to finance the acquisition of assets that will generate long term benefits, or assets that are ultimately self-funding.[1] As Buchanan has correctly noted, the burden of public debt is shifted onto future tax payers. This occurs because future taxpayers repay the debt and their taxes are associated with deadweight losses. Current taxpayers (who may overlap with future taxpayers) cannot accurately forecast the magnitude of future deadweight losses and so cannot entirely discount future interest payments. On the basis that those individuals who directly benefit from government spending should pay for those benefits, government debt should not be used for day-to-day financing of government activity.

Government debt in Australia is low but only because of the efforts that have been made over the recent past to bring debt levels down. According to Australian Bureau of Statistics data (ABS Cat. 5512.0) general government (all levels) is a net lender. The state based non-financial public sector, however, is a net borrower. The ABS defines the function of these organisations as being 'to provide goods and services which are predominantly market, non-regulatory and non-financial in nature, and mostly financed through sales to consumers'. The question becomes whether it is appropriate that these organisations have any debt at all? It is not all clear that they should not have debt. After all, these organisations are characterised only by their ownership status. In some jurisdictions many of these organisations would operate as private firms and their capital structure would be of little concern.

On a total public sector basis all levels of Australian government are in surplus. On a cash basis, however, three of the states are running a deficit with an accumulated deficit of $9.7 billion. The total public sector position for all Australian governments on a cash operating basis is positive.

When evaluating the debt position of the non-financial public sector only two questions arise. First, is the capital structure of public utilities significantly different from those of similar private utilities? Second, are public utilities borrowing money using the state government credit

[1] James M. Buchanan, 1958, *Public Principles of Public Debt: A Defence and Restatement*, (Liberty Fund, Indianapolis, 1999), chapter 12.

rating? If the answer to both these question is 'no' then it is difficult to see any policy or macroeconomic problem arising from this debt.

It is very likely that public utilities are borrowing money using the state government credit rating.[2] If this is the case, then state governments need to include that debt on their own balance sheets. At the very minimum the debt amount should be included as a contingent liability. The issue of interest to us is not related to competitive neutrality, rather it is related to exposure taxpayers have to government guaranteed debt and the proper disclosure of that exposure.

1.2 Empirical evidence

The Productivity Commission (PC) publishes an annual series of reports looking at state-owned enterprises in Australia, 'Financial Performance of Government Trading Enterprises'. The latest report is for the years 2004-05 to 2005-06. Unfortunately, the accounting principles underlying the series have changed in the latest year and comparisons with previous years are highly misleading. The PC is able to show consistent data for the latest two years.

Table 1: Selected data on SOE for 2005-06

	Return on assets	Cost recovery	Debt to total assets	Dividend payout ratio
Electricity	7.8	126.8	41.2	68.5
Water	5.5	163.5	19.9	77.9
Urban Transport	3	66.4	44.4	440.2
Railways	3.8	93.7	17.7	10.0
Ports	7.1	159.2	22.6	39.3
Forestry	2.3	115.4	5.5	91.7

Source: Financial Performance of Government Trading Enterprises 2004-05 to 2005-06 (various tables). Cost recovery is the ratio of revenue from operations to expenses from operations expressed as a percentage. The dividend payout ratio for urban transport is upwardly biased due to a special payment made by TransAdelaide. No other PC monitored urban transport organisation paid a dividend in 2005-06.

[2] See the Productivity Commission, 2002, *Financial Performance of Government Trading Enterprises, 1996-97 to 2000-01*, (Canberra), chapter 5.

To provide some comparison data for utility firms was captured from the Osiris database for 114 UK and US utility firms. Most of these firms were energy utilities. The overall average return on assets was 4.18 per cent and the overall average dividend payout ratio was 61.24 per cent. The overall average debt to total assets ratio was 34.8 per cent. It is not immediately clear that the Australian data is that different from the UK and US comparison firms.

1.3 Conclusion

At present it is unlikely that state debt, via their commercial subsidiaries, is the source of inflation or any other macroeconomic dislocation in the economy. That, however, does not preclude state owned enterprises from causing macroeconomic problems in future.

2. Federalism

2.1 Allocation of functions

There is a large economic literature that investigates Federalism. That literature usually recommends that redistributive powers be allocated to the highest level of government and allocative powers to lower levels of government.[3] The problem with the economic literature, however, is that economists have a very generous definition of what constitutes a federal structure. Wallace E. Oates has argued that economists are concerned with the allocation of resources and income distribution and less concerned with constitutional powers and government autonomy.[4] That may well be true; yet it immediately raises a fundamental problem. When most economists analyse federalism they are not analysing political federations, rather they are comparing the advantages of a centralised, versus decentralised, decision making process. It is unsurprising that a decentralised decision making process is superior to a centralised decision making process.

The Australian Constitution did not originally allocate redistributive powers to the Commonwealth. Section 51 of the Constitution sets out a whole range of matters where the Commonwealth Parliament may legislate for the peace, order and good government of the Commonwealth. Section 51 (xxiiiA) was inserted by referendum in 1946. This allows, but does not require, the Commonwealth to legislate for a range of benefits and family allowances. This section forms the basis of a very large portion of the Australian welfare system. The Commonwealth allocated nearly 67 per cent of the 2007-08 budget to education, health, social security and welfare.

It is common to argue within Australia that national solutions need be found for problems and that harmonisation across the states and territories is desirable. Indeed, many individuals have called for the abolition of the states. This is precisely incorrect. Building on George Stigler's two principles of government

- Representative government works best the closer government is to its constituency
- Subsets of voters have the right to vote for different kinds and amounts of public services for themselves

it is clear that government decision making and resource allocation need to be pushed down the hierarchy of government, not pushed up.

[3] Richard W. Tresch, 2002, *Public Finance: A Normative Theory*, (Academic Press, San Diego), pg. 841.
[4] Wallace E. Oates, 1972, Fiscal Federalism, (Gregg Revivals, Aldershot), pg. 17.

Of course, the Commonwealth does provide benefits in terms of facilitating a large internal market and by maintaining trade between the states and territories. The Commonwealth should maintain those functions and allocate all redistributive functions back to the states and territories.

2.2 Allocation of taxation

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.

2.3 Practicalities

Our proposal has a number of practical advantages. First it does not require any amendment to the Australian Constitution. Second, it places the states and territories on a sound financial footing. There are, however, a number of practical problems and objections that will need to be addressed.

- The state and territory governments' may not wish to levy their own personal income tax. That is their own choice, but if the Commonwealth were to unilaterally exit the provision of funding to health, education and social services, the states will either have to introduce their own income tax, or dramatically cut services.
- A mechanism whereby the states and territories levy the personal income tax would need to be devised. Our proposal is not that the Commonwealth allocate the personal income tax to the states and territories as it does the GST. Each state and territory would levy its own personal income tax with its own rate and base. There may be

Constitutional impediments to the Australian Tax Office collecting the state based personal income tax.

- Differential state and territory personal income taxes and differential service delivery standards may give rise to population mobility. This should not be seen as a disadvantage or objection. Policy competition is a stated advantage of federal systems of government, not a disadvantage.