# Economic Issues

## No. 13

# The 2004-05 South Australian Budget

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**July 2004**

**South Australian Centre for Economic Studies**

ISSN 1445-6826





**Published by:** South Australian Centre for Economic Studies
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## Director's Note

Welcome to the thirteenth issue of *Economic Issues,* a series published by the South Australian Centre for Economic Studies as part of its Corporate Membership Program. The scope of *Economic Issues* is intended to be broad, limited only to topical, applied economic issues of relevance to South Australia and Australia. Within this scope, the intention is to focus on key economic issues — public policy issues, economic trends, economic events — and present an authoritative, expert analysis which contributes to both public understanding and public debate. Papers will be published on a continuing basis, as topics present themselves and as resources allow.

The author of this paper is Jim Hancock, Deputy Director, SA Centre for Economic Studies.

We acknowledge the financial support of our Corporate Members and particularly of the Department of Trade and Economic Development. It enables the preparation of this *Economic Issues* series.

**Michael O'Neil**
**Director**
**SA Centre for Economic Studies**
**July 2004**

## Author's Note

The authors wishes to thank Penny Neal, Michael O'Neil and Jim Wright for comments provided. The views expressed herein are solely those of the author, as are any errors.

# The 2004-05 South Australian Budget

## Overview

The 2004-05 South Australian Budget included substantial new spending measures and modest tax cuts, and has delivered on and maintained commitments to surplus budgeting.

This happy outcome was assisted by favourable economic developments. As a result, taxation revenues turned out significantly stronger than expected in 2003-04 as did GST revenues received from the Commonwealth. They more than offset the impact of higher than planned increases in public sector wages.

Consequently there was a significant budget surplus in 2003-04, in contrast to the small deficit that had been predicted in the 2003-04 Budget.

The strong property market and strong household spending around Australia were the key causes of stronger than expected tax and grants revenues. The State is now doing significantly better with the GST than it would have under the old Commonwealth-State financial arrangements.

Importantly, the upward revisions to expected revenue levels also apply in 2004-05 and through the forward estimates period.

This revenue strength created a dream position for the Government in framing this budget. It meant that the Government could simultaneously advance the objectives of enhanced public services, tax reductions, and fiscal consolidation, whereas normally they have to be traded off against each other.

The most significant new policy measures were on the expenditure side of the budget. They were accompanied by modest tax cuts.

The surprises on the revenue side of the budget, while very welcome, need to be seen as something like a once-in-a-decade lucky break. It will not be so easy to find funds for new spending initiatives – or to fund any unanticipated cost pressures – next year or the year after.

In spite of new spending initiatives, the government sector is projected to grow more slowly than the aggregate economy over the next few years, with the result that its share of the economy shrinks. This result is predicated on holding operating expenses to zero real growth across 2005-06 and 2006-07, an outcome which may not be easy to deliver.

State Government infrastructure spending is to be held at around the relatively low levels seen in recent years. But while the State government spending has been low, infrastructure spending in aggregate has been quite strong in recent years, driven by strong private sector spending. The reduction in State spending is not necessarily a bad thing, as it may reflect more effective culling of projects with weak justification.

South Australia's budget appears to be on a sound medium term course. The challenges now are for government to deliver on its own fiscal objectives, including managing its expenditures within budget, and, at a fundamental level, to ensure that policy settings are supportive of productivity-enhancing growth.

## 1. Introduction

At the end of May the South Australian Treasurer, the Hon Kevin Foley MP, brought down the Government's third Budget.

The Budget included substantial new spending measures and modest tax cuts, but has delivered on and maintained commitments to surplus budgeting.

The Government was able to do this mainly because economic developments during 2003-04 have been very favourable.

This Issues Paper presents an analysis of the Budget. It looks at how changes in the economic environment have affected the Budget, how the government has changed its revenue and expenditure policies, and medium term directions in fiscal policy.

Unless stated otherwise, comments in this review relate to the general government sector, which excludes public trading and financial enterprises.

## 2. Results for 2003-04

The Government estimates that general government net lending will be $264 million for the financial year 2003-04 (at the time of framing the Budget the results for May and June had to be predicted). This is equal to about 2.7 per cent of revenue.

Net lending is the Government's preferred measure of budget balance. The most commonly used alternative, the net operating balance, is expected to show a surplus of $264 million (coincidentally the same as net lending). Appendix A discusses differences between the two measures.

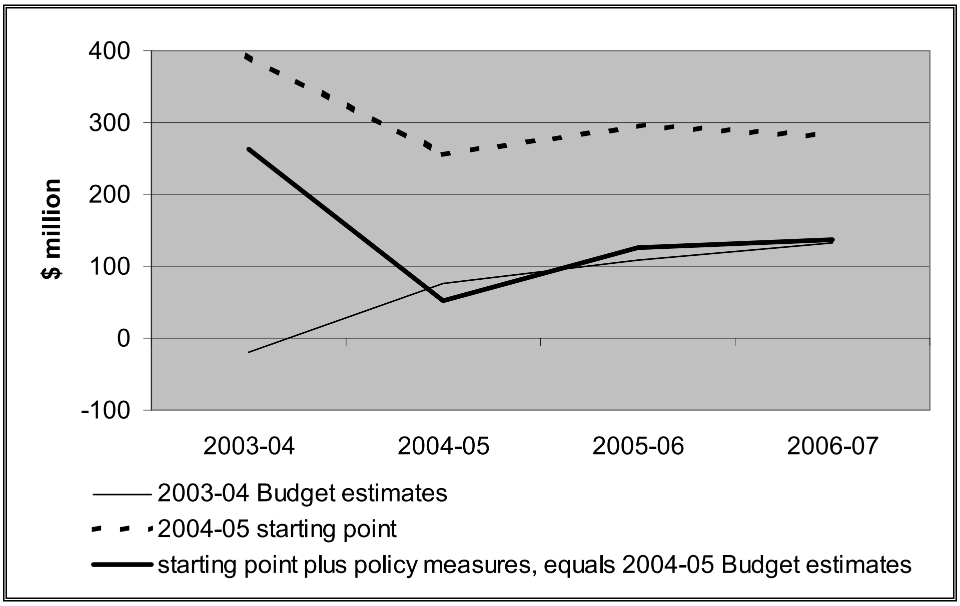
The Budget estimate of net lending for 2003-04 compares with a projection of $20 million net borrowing at the time of the 2003-04 budget a year ago. This means that a substantial surplus is expected in contrast to the small deficit projected a year ago.

It is interesting to examine the reasons for the stronger than expected position, not least because these influences have also affected the Budget's estimates for 2004-05 and later years, and indeed the whole context within which the Budget has been framed.

Treasury explains variations in budget aggregates in terms of "parameter and other variations" (which are essentially those things that affect the budget but do not reflect a direct decision, like stronger than expected growth in the payroll tax base or lower than expected interest rates) and "policy measures" (which are consequences that arise from a new decision to do something with revenue or expenditure implications, like reduce a tax rate or establish a new hospital). The idea is that "parameter and other variations" should cover those things that affect the budget but are largely outside the control of government. In practice this distinction involves judgments about what is, or is not, outside the control of government; for instance, public sector pay settlements are treated as non-policy influences.

Figure 1 employs the distinction between "parameters" and "policy" to show how respective changes in the economic environment and policy decisions have affected the budget. First, it shows the projections of net lending which were made at the time of the 2003-04 Budget. It then shows a "2004-05 starting point", which is simply the 2003-04 figures adjusted to take into account the changes in the economic environment which have affected the estimates.

**Figure 1**
**Estimates of net lending**




Note: "2003-04 Budget estimates" are as published in the 2003-04 Budget. "Starting point" adjusts the 2003-04 Budget estimates to take into account economic and other non-policy developments which were known of at the time the 2004-05 Budget was framed. Adding on policy measures that have been adopted since the 2003-04 Budget gives "2004-05 Budget estimates".

It can be seen that these changes in the economic environment pushed the budget strongly in a surplus direction (they amounted to $413 million).

The favourable changes in the economic environment were on the revenue side. Taxation revenues were $320 million stronger than expected, Commonwealth grants came in $152 million above expectations, and there was some further good news on smaller revenue items. On the expenditure side of the budget, economic developments were unfavourable to operating expenses, but not by enough to use up all of the windfall gains on the revenue side.

There is always a question as to whether favourable economic developments reflect conservatism in the prior estimates or genuine surprises in the outcome. While conservatism may have played a part, there is no doubt that there has been an unusually favourable run of surprises in the budget outcome for 2003-04. Two factors of particular significance have been the stronger than expected local property market, and stronger than expected domestic spending around Australia, which has boosted GST revenues.

Figure 1 also shows the effect of policy measures taken since the 2003-04 Budget. Once we add them onto the "starting point", we have the actual estimates in the 2004-05 Budget. Policy measures pushed the budget balance in a deficit direction by $128 million. These policy measures all had their influence on the expenditure side of the accounts. Taken together, they added 1.4 per cent to the expenditure level that was budgeted in the 2003-04 Budget.[1]

## 3. Budget for 2004-05 and later years

State Treasury's view is that the favourable developments in the economic environment – stronger than expected GST and State tax revenues in particular – will persist. This means that they have affected the projections for 2004-05 and beyond, which can also be seen in Figure 1 and in Table 1. Table 1 shows that for the triennium 2004-05 to 2006-07, favourable changes to the economic assumptions lying behind the budget have increased net lending by $513 million.

**Table 1**
**The impact of "parameter variations" and "policy" over the triennium 2004-05 to 2006-07**

| | 2003-04 Budget estimate | plus: effect of parameter and other variations | plus: effect of policy decisions | equals: 2004-05 Budget estimate |
|---|---|---|---|---|
| **Revenue** | | | | |
| Revenue - taxation | 7,881 | +746 | -132 | 8,495 |
| Revenue - other | 20,890 | +1,166 | +58 | 22,112 |
| **Total revenue** | **28,771** | **+1,912** | **-74** | **30,607** |
| **Expenditure** | | | | |
| Operating expenses | 28,256 | +1,355 | +584 | 30,197 |
| Net capital investment expenditure | 197 | +44 | -145 | 95 |
| **Total expenditure** | **28,453** | **+1,399** | **+439** | **30,292** |
| **Net lending** | **319** | **+513** | **-516** | **315** |

The improvement in the budget outlook is due to welcome surprises on the revenue side of the budget. After taking a more up to date view of key tax bases and Commonwealth grants (which to a large extent are driven by the Commonwealth Government's GST collections), but before allowing for policy decisions, the revenue estimates for the period 2004-05 to 2006-07 have been revised up by $1,912 million (6.6 per cent).

This reflects strength in State taxes (especially property taxation) and in other revenues, especially Commonwealth grants (due to strength in nationwide GST collections).

One of the advantages claimed for the GST prior to its introduction was that it would give the States access to a tax base growing with the economy, and this is now evident. The recent Commonwealth Budget estimated that GST revenues to be provided to South Australia over the three years 2004-05 to 2006-07 will be about $408 million more than what would have been available under the pre-GST grant arrangements.[2]

Economic developments have also affected forward estimates of expenditures. They have been revised upward substantially (by $1,399 million over the triennium) to take account of reductions in projected net interest expenses, changes in provisions for future policy decisions and employee expenses, accounting variations since the mid-year budget review (MYBR), and the flow through of specific purpose payments.

It appears that the most prominent of these economic influences on expenditures is public sector wage settlements, which have included higher rates of pay increases than had previously been assumed. In the budget, public sector wage settlements are treated entirely as "non-policy" influences, even though they arguably do entail an element of policy choice. Projected employee expenses over the triennium 2004-05 to 2006-07 are $747 million (5.8 per cent) higher than what was included in the 2003-04 Budget. Part, although not all, is due to higher than expected pay settlements.

Data from the ABS Wage Cost Index shows movements in South Australian public sector wages (they are dominated by State Government employment). While data is available only until the March quarter 2004, it is apparent that even if only a modest increase is recorded in the June quarter the 2003-04 increase will be in the range 4 to 4¼ per cent, which is up from results in the 3¾ to 4 per cent range over the previous three years.

Taken collectively, economic developments in 2003-04 have been a Treasurer's dream. They have pushed the budget outlook significantly in a surplus direction by $513 million. That in turn has meant that the government has had room to increase spending, cut taxes, and/or boost its surplus, all at once. Normally Governments have to make painful trade-offs between these objectives.

Figure 2 shows how the Government has used its budgetary windfall. The line described as "starting point" shows what the budget position would have been if the government had simply kept the budgetary windfall as a bigger surplus. The line "plus revenue policy measures" brings to the account the policy decisions made on the revenue side, and it can be seen that these cause a small reduction in the net lending estimates.

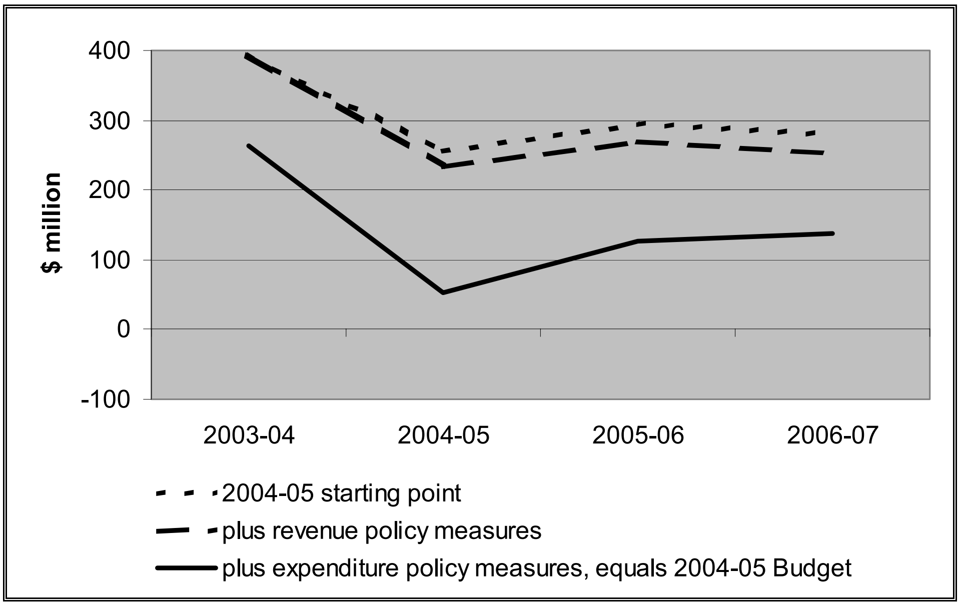
The main tax measures announced in the Budget are:

- the payroll tax rate will be reduced from 5.67 per cent to 5.5 per cent from 1 July;
- stamp duty concessions are now available to first home buyers on purchases of homes with a value up to $250,000, instead of the previous maximum of $130,000;
- loans taken out by first homebuyers are now exempted from mortgage duty; and
- lease duty and cheque duty will be abolished from 1 July.[3]

Their effect is to reduce taxation receipts by $132 million over the triennium 2004-05 to 2006-07.

Offsetting this to a degree are some agency revenue measures. In total, revenue policy decisions decreased revenues by $74 million, or 0.2 per cent, over the triennium.

**Figure 2**
**Impact on net lending of policy measures since 2003-04 Budget**




Note: "Starting point" adjusts the 2003-04 Budget estimates to take into account economic and other non-policy developments which were known of at the time the 2004-05 Budget was framed. Adding on revenue policy measures and then expenditure policy measures that have been adopted since the 2003-04 Budget gives "2004-05 Budget estimates".

Returning to Figure 2, the line "plus expenditure policy measures, equals 2004-05 Budget" builds in the impact of policy measures on expenditures. It can be seen that these cause a quite large reduction in the net lending estimates. The net boost to expenditure over the triennium 2004-05 to 2006-07 from policy decisions taken since the 2003-04 Budget was $439 million (1.5 per cent).

Figures in the Budget Papers (prepared on a four year basis) show that more than 60 per cent of the new spending is in the human services portfolio covering additional hospital services, mental health reform, increased child protection services, and additional services on the Anangu Pitjantjatjara Yankunytjatjara Lands. There are also new literacy measures at junior primary school level, additional funds for geo-scientific databases, marine industries innovation, road infrastructure, additional police, etc. There is always a large number of initiatives which make up the budget, but in this case their combined magnitude is quite substantial. Certainly it will not be possible for Government to make new commitments like this repeatedly without making substantial savings initiatives to fund them.

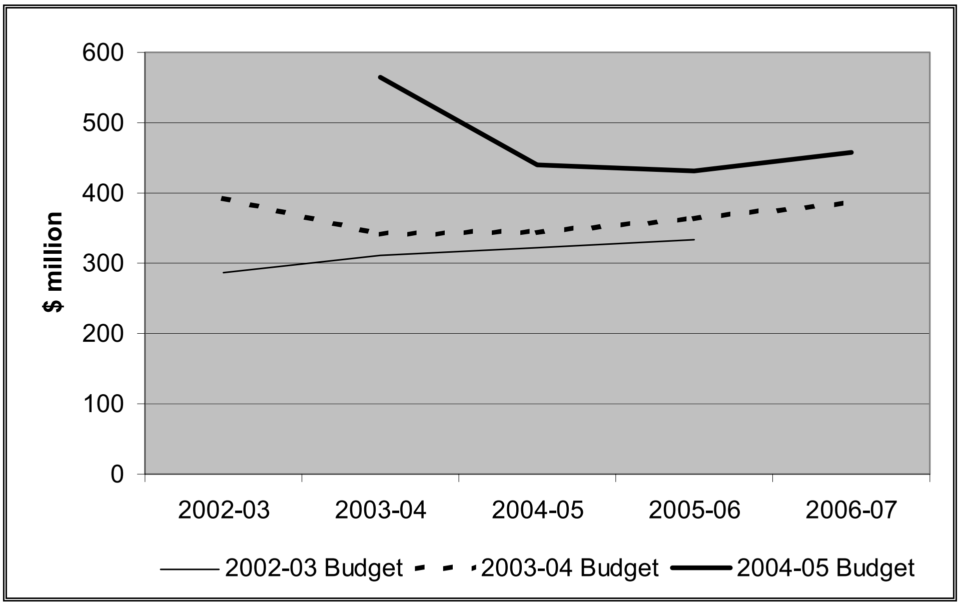
It is notable that the budgeted expenditure increases occur "up front", in the sense that there is no real growth allowed for in 2005-06 and 2006-07. This may be difficult to deliver. Under realistic assumptions about public sector wages growth, it would require reductions in staff numbers or reductions in other areas of expenditures. And some of those other areas of expenditure do not offer much scope for budgetary adjustment: government cannot do much to change depreciation, interest expenses or superannuation interest expenses. So while the budget projections show a policy of very restrained spending over the forward estimates, there is a question as to how they will be achieved.

The end result of these tax cuts and new spending measures is a projected series of budget surpluses which are not much different to what was planned in the 2003-04 Budget.

The reduction in conveyance duties on first homebuyers can arguably be seen as a partial refund of an unintended windfall associated with sharp rises in property prices. Over the 5 years to the end of 2003, Adelaide's established house prices are estimated by the ABS to have risen 95 per cent, which had the effect of bringing first homeowners into price brackets where conveyance duties of several thousand dollars are payable. The enhanced first homeowner concessions may therefore be seen as the cancellation of an element of this revenue gain. As it is, even after the tax reductions in this Budget, prospective conveyance duties are considerably higher than was expected at the time of the last changes to property tax rates, in the 2002-03 Budget as illustrated in Figure 3.

In fact conveyance duties are projected to yield substantially more revenue than land tax and the emergency services levy combined. It is difficult to believe that conveyance duties are more equitable as tax instruments than broad based land taxes. It is also difficult to believe that they are more efficient, as they can add quite substantial costs to moving house, which allows people to adjust to changing life circumstances and, in the process, periodically reallocates the housing stock in line with changed life circumstances.

**Figure 3**
**Estimates of conveyance duties**




## 4. Performance against fiscal targets

In its first Budget (2002-03) the Government announced the following fiscal targets:

- *"non commercial sector underlying cash balance or better in 2002-03 and across the forward estimates*
- *"from the end of the current Parliamentary term the Government will target budget outcomes of average zero net borrowing in the general government sector over any four-year term"*

The non-commercial sector has since been de-emphasised in the fiscal strategy, and is not discussed in the Budget documents. However, it is similar to the general government sector, and budget data shows surpluses for the period 2003-04 through 2007-08.[4]

The emphasis now is very much on the second target as a measure of budget balance. Overall the budget remains on track to achieve that target – and in fact to exceed it. A favourable economic climate has been a key contributing factor. It has produced significant unanticipated gains in revenues which has in turn allowed a combination of increased spending and modest tax reductions while still exceeding the budget balance target.

## 5. Economic outlook

There is as always a question as to the realism of the budget projections, and in particular whether the underlying economic assumptions are reasonable.

The Budget assumes real GSP growth of 2½ per cent in 2004-05 and 2¾ per cent per annum over the forward estimates. Employment is assumed to grow ¾ per cent in 2004-05 and 1 per cent per annum over the forward estimates. It is noted in the Budget that these assumptions are consistent with historic trends. They are quite reasonable as medium term "planning" assumptions.

National economic outcomes also have an influence on the State Budget via their impact on the Commonwealth's GST collections. It seems likely that, over the coming phase of the economic cycle, overseas trade will become more prominent as a growth driver in lieu of household spending and, as exports are GST-free, we may see slower growth in the GST base. This influence appears to have been taken into account in the Commonwealth's GST projections, at least to a degree.

The key risk to both the State and Commonwealth economic growth assumptions is that households' adjustment to the end of the property boom and their own high debt levels puts more of a brake on their spending than is allowed for in budget assumptions. The extent of the likely downturn in residential construction activity is also an area of uncertainty.

Public sector wages growth is also an important influence on the State Budget estimates. It appears that a deceleration in public sector wage increases has been assumed in the estimates. There is some room in provisions to accommodate higher wage settlements; whether it is sufficient remains to be seen.

## 6. Medium term trends

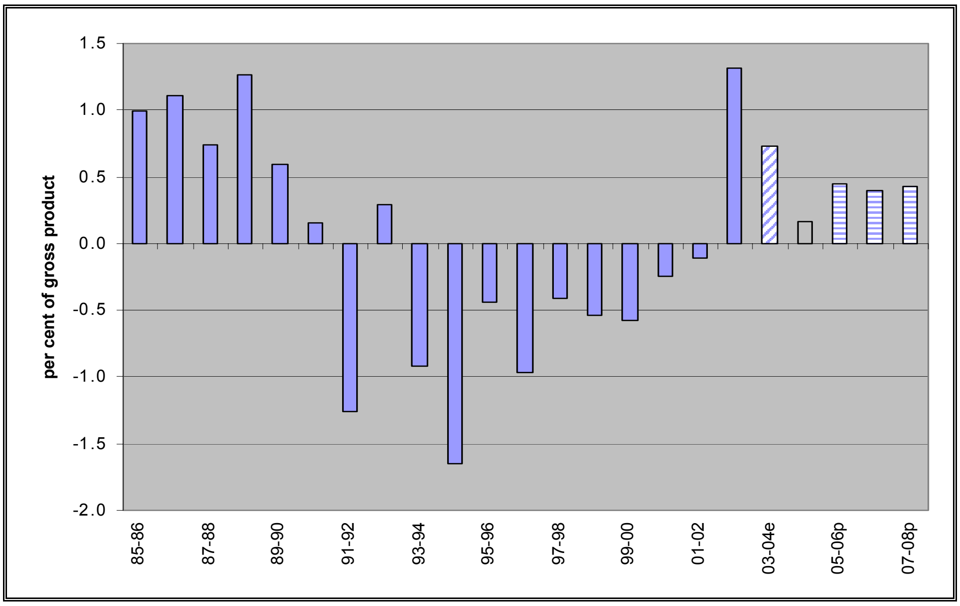
A better feel for the current budget settings can be had by looking at the longer historical context. Unfortunately, the accrual-based framework that is now used to present the Budget and its fiscal targets is available in a meaningful form only since 1998-99. An alternative is to consider cash flow information, which is available over a longer time, albeit with some risk of anomalies in the data.

Figure 4 shows trends since 1985-86 in net cash flows (from operating activities and investments in non-financial assets) for the general government sector. It is a reasonably close analogue to the "net lending" measure which is emphasised in the Budget.

Figure 4 shows that net cash flows were in substantial surplus in the late 1980s and 1990-91, but that those surpluses disappeared by 1991-92 due to a much weaker economy and emergence of the State Bank losses. Although there was a temporary improvement in 1992-93, relating partly to emergency support provided by the Commonwealth, the cash position did not show a sustained improvement until the second half of the 1990s. In 2002-03 a surplus was achieved, and this was repeated in 2003-04. The outlook is for moderate ongoing cash surpluses. These surpluses are clearly not as large (relatively) as those recorded in the late 1980s.

An important factor to note is that in the late 1980s it was common in respect of public sector superannuation to make cash payments sufficient only to cover benefit payments. Now it is practice to make payments equivalent to accruing liabilities plus a contribution to sink liabilities in respect of past services. This change in practice would explain some, and possibly even all, of the difference between contemporary cash flows and those of the late 1980s.

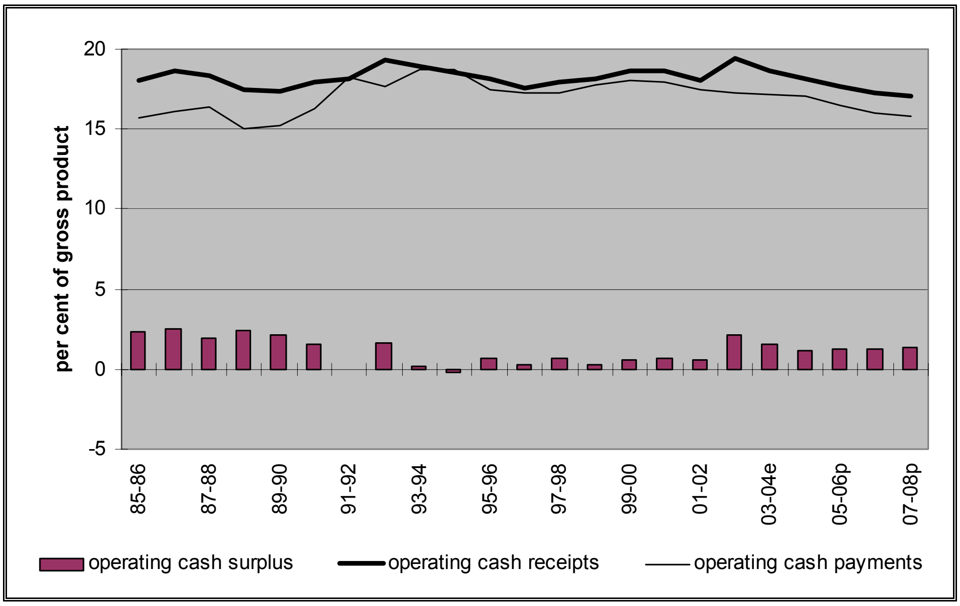
**Figure 4**
**General government net cash flows**




Note: Data is shown for net cash flows from operating activities and non-financial investments
Source: ABS State Accounts and unpublished GFS data, SA Treasury Time Series data and GSP projections, SACES' consistent historic GSP estimates and ratio calculations.

Figure 5 shows cash flows from operating activities. The interesting point is that in spite of new spending and revenue gains in this budget, the ratios of operating cash receipts and cash payments are projected to decline as a proportion of gross state product. According to this measure at least, the general government sector's operating activities are projected to shrink relative to the size of the economy.

**Figure 5**
**Operating cash flows**



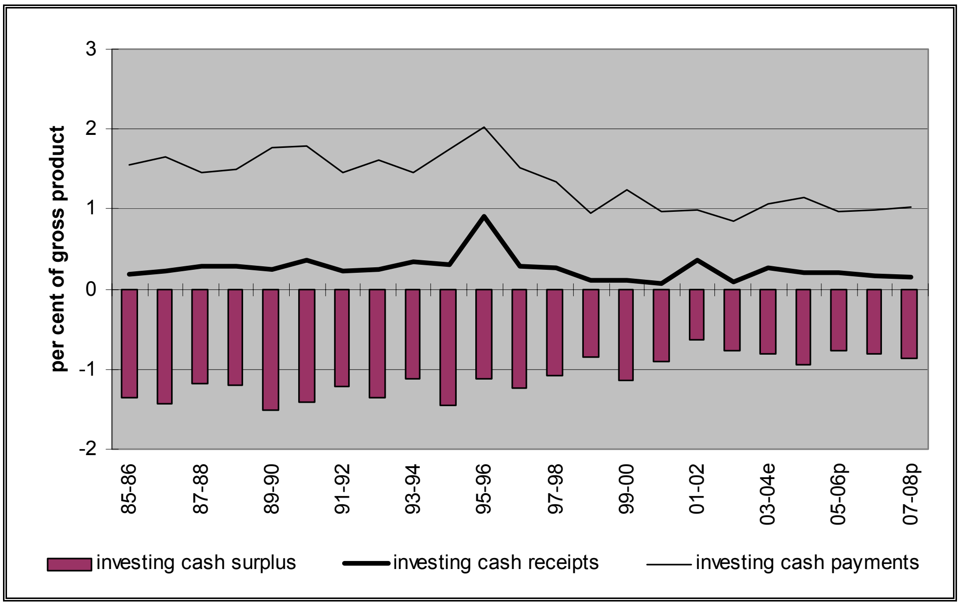

Note: Data is shown for general government net cash flows from operating activities.
Source: ABS State Accounts and unpublished GFS data, SA Treasury Time Series data and GSP projections, SACES' consistent historic GSP estimates and ratio calculations.

Figure 6 shows general government net cash flows from purchases and sales of non-financial assets. Purchases of non-financial assets are projected to remain at about the same levels as have been seen since the late 1990s. However, these levels are relatively low by historic standards, being about one-third less than what was seen over the period from the late 1980s through to the mid 1990s.[5] Perhaps, in part, because of this, there have been concerns voiced that the budget did not provide sufficient resources to infrastructure.

However, even though State government infrastructure spending is at relatively low levels, it does not follow that aggregate infrastructure spending is at low levels. As Figure 7 shows, private engineering construction expenditures have been strong in recent years and have compensated for low public infrastructure spending. The end result is that aggregate infrastructure spending has also been quite strong.[6]

That conclusion is reinforced if one allows for the fact that these figures do not include spending on the Alice Springs-Darwin rail link. The South Australian Government contributed $100 million to that project in the belief that it would benefit South Australians, even though the works are not in South Australia.

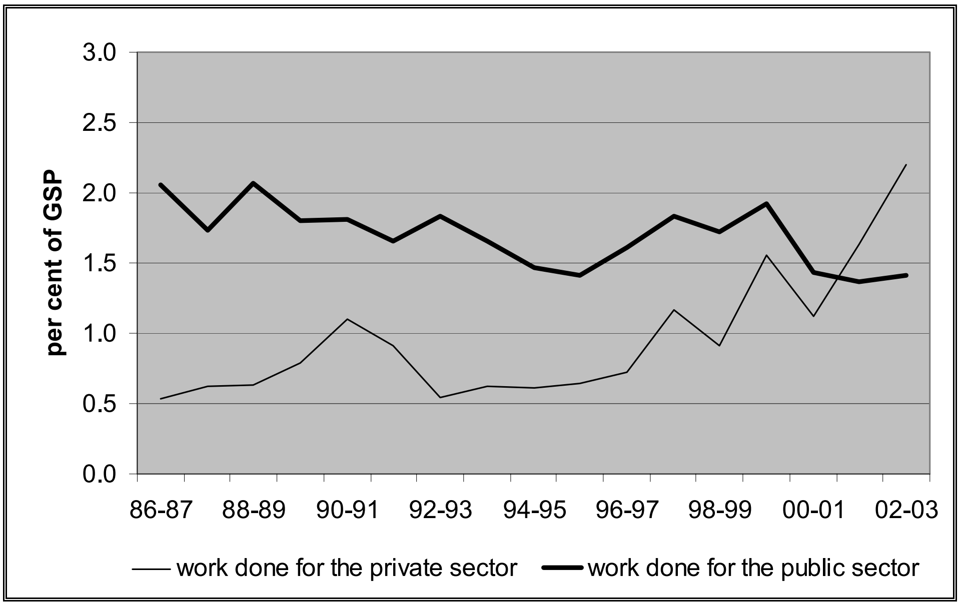
**Figure 6**
**Investment cash flows**




Note: Data is shown for general government net cash flows from non-financial investments (i.e. asset sales less asset purchases)

Source: ABS State Accounts and unpublished GFS data, SA Treasury Time Series data and GSP projections, SACES' consistent historic GSP estimates and ratio calculations.

**Figure 7**
**Engineering construction**




Source: ABS *State Accounts* (Cat. No. 5220.0) and *Engineering Construction* (Cat. No. 8762.0)

Anyway, one needs to be careful about using changes in the level of infrastructure spending over time to indicate the adequacy of current spending levels. The relative strength of private infrastructure spending, and therefore total infrastructure spending, shows that public spending is only part of the story. In the absence of public sector spending it is possible still to have strong private sector spending.[7]

Even if there is lower spending on the types of infrastructure traditionally provided by the public sector, this is not necessarily a bad thing. It might, for instance, reflect a reduced proportion of unjustified projects winning funding. In this context, two factors that may have contributed to lower infrastructure spending are:

- better screening of infrastructure proposals in the funding approval processes (unambiguously a positive development); and
- increased requirements for beneficiary contributions to infrastructure projects (possibly a positive development).

Each of these has the potential to screen out project proposals for which societal benefits are less than societal costs. The challenge is to maximise the extent to which unjustified projects are stopped, while minimising the extent to which justified projects are, mistakenly, stopped from proceeding.

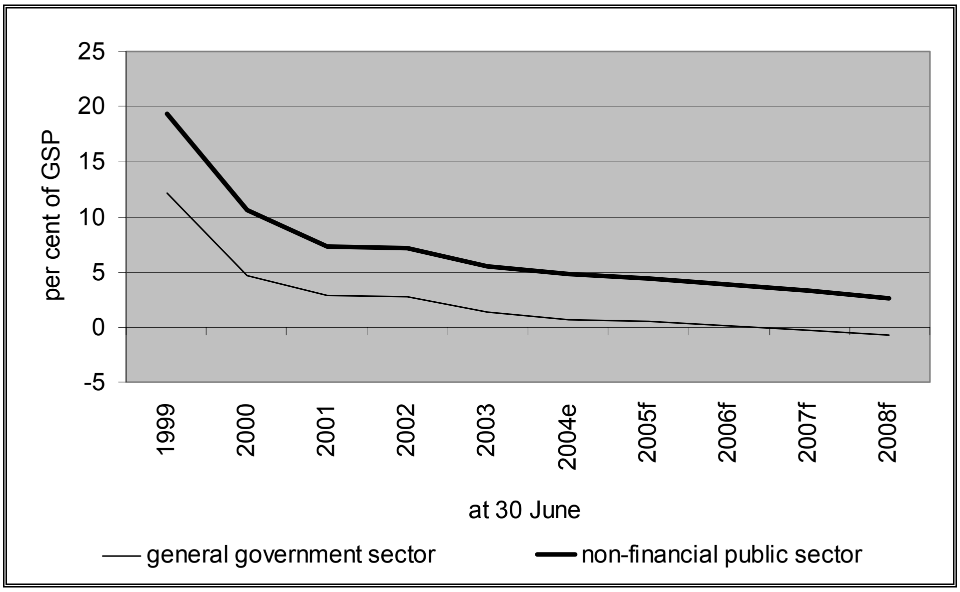
This discussion must finish on an inconclusive note. The adequacy of infrastructure spending will not usually be determined by a simple examination of whether spending has gone up or down. Instead, the challenge for proponents of the view that infrastructure spending is inadequate is to identify specific, justified projects which are not going ahead. Where a project cannot proceed because beneficiaries are unwilling to fund it or to take the risks associated with it, we need to think twice about whether the project really is justified. Sometimes there will be good reasons why they cannot. But at other times infrastructure demands exist only because someone else – usually government – is paying for it or taking the risks.

## 7. The balance sheet

Recent budget surpluses have brought about a continuing reduction in the net debt of the general government sector (Figure 8). General government net debt is projected to become negative by 2006 (which would mean that holdings of debt securities including cash actually exceed debt on issue).

In years gone by, the practice was to focus on the net debt of the non-financial public sector which encompasses, in addition to the general government sector, public trading enterprises. The net debt ratio for the non-financial public sector is also shown in Figure 8. The ratio is projected to fall to 4.8 per cent of GSP by mid 2004. A gradual downward trend is now in place, following the rapid reductions at the time of the electricity sales in the period 1999 to 2001. In the first half of the 1990s the ratio was above 25 per cent.

**Figure 8**
**Net debt**




Source: GSP – ABS State Accounts data and SA Treasury projections; net debt – State Treasury

In fact, in recent years the States have, in their budget documents, generally reduced the degree to which they emphasise net debt levels as an indicator of balance sheet health. This is a good thing. Net debt is only part of the liability picture for States. Unfunded superannuation liabilities also entail future payment obligations which significantly influence future fiscal circumstances.

The budget papers report a substantial rise in unfunded superannuation liabilities in 2003-04, but this is driven by changes in valuation practices, rather than changes in the expected liability and asset values upon crystalisation. To calculate unfunded superannuation liabilities it is necessary to choose a discount rate to discount future cash flows, and a more conservative assumption has been employed in this Budget, in anticipation of a change in accounting standards.[8]

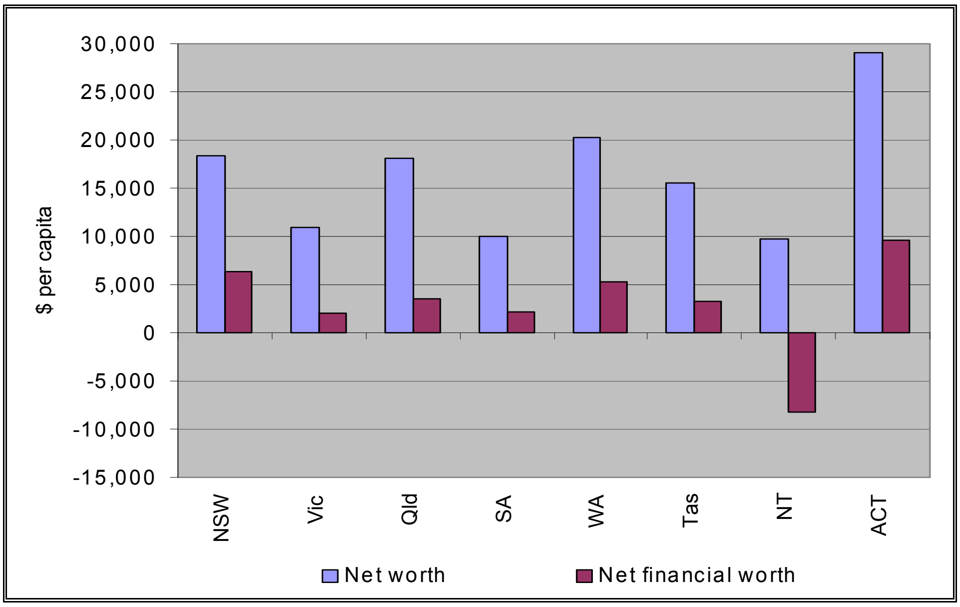
Furthermore, while net debt and liability data can be meaningful when interpreted carefully, there are important qualitative differences between liability reductions achieved via, on the one hand, privatisation and reductions in capital formation and, on the other, surpluses on operating activities. These differences can easily be illustrated with the example of a homeowner with a mortgage. She could reduce her mortgage by selling her home. Or she could reduce her mortgage by keeping up mortgage payments while failing to carry out essential capital works to preserve the property (e.g. replacing a leaky roof). But neither of these strategies makes the owner better off. On the other hand, reducing the mortgage and keeping up maintenance on the property improves the subsequent financial position of the owner: she owns the well maintained property and has less debt on it. Liability measures by themselves give an incomplete view of the State Government's financial condition.

For this reason there is now increased attention paid to measures such as net financial worth and net worth. Figures in the Budget paper show that South Australia's per capita net financial worth is quite low; $2,215 in mid 2004. This is a little bit higher than Victoria, but still very much at the bottom end – less than in the other States, and in fact less than half the levels of NSW, WA and ACT (Figure 9). NT has a negative net financial worth.

These differences have accumulated over many years. It would be difficult to make a precise attribution to any one event, and many "plus" and "minus" items would need to be taken into account. However, there is probably a sufficient explanation for South Australia's low level in the large losses incurred by the State Bank in the early 1990s.

Differences from State to State (and over time) in net financial worth have a practical implication in that governments can expect to earn financial returns on net financial worth. Higher net financial worth will typically have higher net earnings associated with it, and these higher earnings can then be used to fund higher service levels or lower tax levels.[9]

**Figure 9**
**Net worth and net financial worth**




Source: State and Territory budget papers for balance sheet data, Commonwealth Budget Paper No 3 for December 2003 population estimates.

The fact that these differences exist does not give any clear guidance on whether steps should be taken to change them. The only way to do so would be to vary the Government's net saving (i.e. its net lending). And this raises an interesting question as to whether, and how much, government should save on behalf of citizens.[10]

## 8. Thinking about fiscal strategy

Before we address the question of what fiscal strategy should be, we need to ask why it matters at all. We need to know what we want from fiscal strategy before we can determine what it should be.

The primary purpose of fiscal strategy must be to contribute to sustainable increases in the living standards of the South Australian community. Those living standards encompass not just cash incomes, but also employment opportunity, environmental standards, feelings of security and community, and so on. Obviously many of the detailed decisions that make up the budget – and ideally all of them – address the objective of living standards in some way. The budget balance does not directly address growth objectives, but it has a potentially significant effect on the confidence of investors, which in turn may affect the capacity of the economy to generate sustained increases in living standards.

A secondary objective of fiscal strategy is to achieve intergenerational equity; secondary because sustained increases in living standards are likely to do much more for future generations than any fine adjustments of fiscal burdens over time. In any case, many things that are desirable on intergenerational equity grounds are also desirable in terms of living standards – e.g. maintenance of environmental stocks.

In South Australia prospective demographic trends, coupled with moderately optimistic assumptions about productivity growth, suggest that there will actually be a modest diminution of demographically-induced fiscal pressures over the coming five to ten years.[11] Although the dependent elderly population will rise moderately there is an offset in the form of a shrinking dependent young population. But after that fiscal pressures are likely to build, and at an accelerating rate, as the dependent elderly population increases more rapidly.

But demographic effects are only part of the story. Productivity growth rates are very important. In fact a moderate increase in growth – say a quarter or a half a percentage point per annum – could significantly ameliorate any adverse demographic effects which will occur over the next 20 to 25 years. And a crucial point to understand is that a modestly stronger growth rate, sustained over a period of years, will do much more for the budget than a modestly higher surplus could, at least in a direct sense.[12]

So how does fiscal strategy impinge on growth? The connections are imprecise, but certainly real. At the overarching level, there is a general acceptance that business and investor confidence will be enhanced if the budget is run in a way that is sustainable. Deficits could of course be managed easily enough in the short term, and might be warranted under certain circumstances such as economic downturns or when abnormal capital works spending is required. But if the budget settings are such as to imply deficits in the medium term, it raises the prospect that painful adjustments will be needed later on. And while businesses and investors might be myopic enough to ignore this, the conventional wisdom is that they are not so myopic, especially when the investments under consideration have a long life. So it is desirable that the budget be seen to be sustainable.

This probably does not mean that governments now need to be making major adjustments to deal with demographic changes which have real force a decade and more into the future. We must acknowledge the difficulty of predicting the nature of the world 25 or 50 years hence. We should not lose sight of the medium term to deal with the long term – after all, we only get to the long term via the medium term. But it is important for government to show that it is attuned to the demographic changes that we will face and that it is pointing policy in the right direction.

These considerations suggest that the right fiscal strategy for South Australia, in the sense of showing an acceptable degree of preparation for the future without actually locking into costly decisions too soon, is one of moderate surpluses over the forward estimates period – which is what we have. But this fiscal strategy needs to be accompanied by other policies which sustain and build living standards.

## Appendix A
## Analytic indicators for the Budget

Two of the main summary measures for the Government Finance Statistics' (GFS) accrual operating statement are the net operating balance and net lending.

The ***net operating balance*** is equal to accrual revenues less expenses. Revenues and expenses do not include transactions in assets but include some items which are not the subject of transactions, the most significant being depreciation expenses and accruing superannuation liabilities.

***Net lending*** is equal to the net operating balance less net acquisition of non-financial assets. The main practical difference is that net lending includes gross fixed capital formation and excludes depreciation. This means that the difference between net lending and the net operating balance relates largely to the extent to which, within a year, depreciation charges are sufficient to cover the costs of gross fixed capital formation.

There are differences between the States in their choices of summary budget measure. South Australia, New South Wales and Tasmania highlight net lending. Victoria, Queensland, Western Australia, the NT and the ACT use the net operating balance.

The decision about which measure to focus on then depends on what one is seeking to identify. Net lending measures the extent to which the government's current period purchases of resources are met from current period revenue collections and, related to this, the degree to which it has to draw on the capital markets to finance its activities. However, net lending does not distinguish between resources which are used to build long-lived assets and resources used up in current consumption, and in some contexts the distinction is important.

The net operating balance excludes the purchase of long-lived assets and instead includes depreciation which is an estimate of the extent to which existing long-lived assets are consumed. The net operating balance is thus focused on the consumption of resources, in contrast to a focus on acquisitions of resources with the net lending concept.

In our view the net operating balance is generally the better indicator of whether the budgetary settings in place are consistent with "paying our way". Surpluses and deficits on the net operating balance also flow directly to net worth measures.

Net lending is rather more vulnerable to the presentation of transactions than is the net operating balance. For instance, the purchase of a physical asset goes straight to the net lending bottom line whereas the lease of the same asset would not. But the depreciation and cost of capital associated with the asset would tend, under either arrangement, to flow into the net operating balance.

However, net lending is sometimes emphasised because it embodies a conservative view on non-financial assets, recognising their costs up front rather than spreading it over their useful lives. Such an approach may be warranted especially where there is some doubt about the value of services provided by assets. For instance, in the 2002-03 Budget the South Australian Government explained its emphasis on net lending in the following terms:

> *The Government's long term objective is for general government operating expenses and investing expenditure to be met entirely by revenues. The fiscal targets do not distinguish general government investing expenditure from operating expenditure. General government investing expenditure is not undertaken to generate future revenue streams and therefore must be met from current revenue streams or operating surpluses. This target ensures no growth in general government net debt from operating or investing expenditure.*

# End Notes

1 This figure refers to policy measures net of changes in provisions. Gross policy measures cost $157 million, but $29 million of this was able to be met from provisions.

2 See Commonwealth Budget Paper 3, *Federal Financial Relations 2004-05,* Table 13.

3 In addition bank accounts debits tax will be abolished from 1 July, although this is not a new measure. The States committed to do this under the GST agreements with the Commonwealth.

4 Based on the item "net cash from operating activities and investments in non-financial assets" in the Uniform Presentation Framework.

5 Significant investments in non-financial assets are carried out in the public trading enterprises sector. If we consider an investment measure encompassing public trading enterprises, the decline is more pronounced, partly because the privatisation of the State electricity assets has taken most electricity investments off the public account.

6 The sectoral trends (but not the total) have been affected in a statistical sense by the transfer of electricity from the public sector to the private sector.

7 It might be argued that private sector infrastructure cycles are undesirably volatile, and that public presence is warranted on "smoothing" grounds. If that argument were accepted, the low level of public activity at present would seem to be an appropriate response from a demand management perspective.

8 The change, introduced in the Mid-Year Budget Review 2003-04, involves using a risk-free rate of 6.0 per cent rather than the expected earning rate of 7.5 per cent.

9 An argument can be put to consider net worth instead of net financial worth. Net worth includes, in addition, physical assets such as roads, government buildings, land holdings, etc. In most instances these physical assets will have service streams associated with them. However, as the valuations of physical assets are generally subject to larger amounts of guesswork than financial assets, it is common to focus on net financial worth instead. Comparisons of per capita net worth also show South Australia having levels which are smaller than most other States.

10 Net lending bears directly on net financial worth. The operating result bears directly on net worth. The operating result is perhaps the more "pure" measure of saving, but net lending recognises the illiquidity of many physical assets acquired by government. See also Appendix A.

11 The consequences of demographic change for the South Australian budget are explored in some detail in *Budget Implications of South Australia's Demographic Trends*, a report prepared by SACES for SA Business Vision 2010 (2003) http://www.sabv2010.com.au/

12 Under Australia's fiscal equalisation arrangements the State Budget is affected more by national than State productivity trends. Of course State incomes are predominantly affected by within-State productivity trends which gives a compelling reason to pursue them.