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The 2001-02 South Australian Budget

Author:
Mr Jim Hancock
Deputy Director (Projects)
South Australian Centre for Economic Studies

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PO Box 125
Rundle Mall SA 5000
AUSTRALIA
Telephone: (61+8) 8303 5555
Facsimile: (61+8) 8232 5307
Internet: http://www.adelaide.edu.au/saces
Email: saces@adelaide.edu.au

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Editor's Note

Welcome to the first issue of *Economic Issues*, a series to be published by the South Australian Centre for Economic Studies as part of the Centre's 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 authorative, 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.

This first issue of *Economic Issues* presents an analysis of the 2001-02 South Australian Budget. It does so from a macroeconomic perspective, analysing the Budget outcomes and objectives within the overall context of the financial position of the State. The analysis highlights the continuing financial challenges (and difficulties) facing future South Australian Governments if they are to meet the aspirations and expectations of the community in respect of both the provision of public services and the promotion of higher living standards through economic growth.

The author of this paper is Mr Jim Hancock. Jim Hancock is Deputy Director of the SA Centre for Economic Studies. He has applied economics expertise in a range of areas, including macroeconomic performance and growth, cost-benefit analysis, environmental evaluations, competition policy, regulatory issues and public finance. He has particular skills in applying economic concepts to public policy issues. Jim joined the Centre in 1998; prior to joining the Centre, he worked in the South Australian Department of Treasury and Finance.

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Kevin Kirchner
Editor
28 August, 2001

The 2001-02 South Australian Budget

Summary

The 2001-02 South Australian State Budget shows that the cash budget for the non-commercial sector is approximately in balance and is on track with the targets set out in the Financial Plan of 1998-99. However, the Budget is well short of the targets for the accrual operating result, mainly because recurrent spending has run above projections. A consequence of these trends is that the Budget continues to fall well short of the objective of financing capital requirements from a surplus on the operating result.

The bottom line is that South Australia's budgetary position remains fragile and under considerable stress.

South Australia's balance sheet is weak compared with the other States, in the sense that net financial worth (and net worth) are, in per capita terms, well below the Australian average across all States. This situation has evolved over time, and is unlikely to have been much influenced (in either direction) by recent asset sales. The medium term consequence is to limit the choices available to the South Australian community. At average levels of efficiency, South Australia either has to tax harder than other States to deliver average levels of services or, alternatively, to have average tax levels South Australia has to accept lower service levels. The only other option is to run Budget deficits − which in an accrual sense appears to have been the recent practice in South Australia. But this is not a sustainable long term approach.

The best way to address South Australia's budgetary disadvantage is to raise the efficiency of Government service provision above average. This means achieving a strong level of productive efficiency. It also means ensuring allocative efficiency − for instance ensuring that government services are not employed as a costly mechanism to achieve distributive objectives which could be reached more efficiently with cash transfers.

1. Introduction

In May 1998 the South Australian Treasurer announced a four year financial plan for the period 1998-99 to 2001-02. Three years into the Plan, it is apparent that:

- in cash terms, and excluding asset sales proceeds, the Budget has been approximately in balance to date;
- achievement of this result has been by means of reduced payments in respect of past service superannuation and lower than expected capital spending;
- accrual budget information, although incomplete, suggests that the Government's ongoing operations have made a small draw on the State's net wealth since the Plan commenced;
- gross liabilities have been significantly reduced, but this has been achieved by privatisations which at best guess are likely to have been broadly neutral on the State's net worth; and
- South Australia's public sector has low net worth in per capita terms.

The net result is that South Australia's budgetary position remains fragile and stressed. The low net worth of the South Australian public sector means that, unless the South Australian Government can lift the efficiency of its own budgetary operations above national average levels, it will need to levy above average taxes just to provide average levels of services. In these circumstances, it is essential that the Government gives careful consideration to all decisions concerning the provision of services, but especially decisions regarding the mix and manner of delivery of services, so as to ensure efficient outcomes.

This report identifies and analyses the above issues. In the analysis that follows it is important to bear in mind the distinction between the "whole of government" and government "non-commercial sector" accounting entities. "Whole of government" means the entire State public sector as a consolidated entity. This comprises both non-commercial and commercial entities. Publicly owned entities which operate in the commercial sector tend to have relatively narrow commercial objectives (although these may sometimes be influenced by means of so-called 'community service obligation' payments by government) and their financial results tend to reflect market conditions. In contrast, the government non-commercial sector is generally subject to more direct management control by government. It involves most taxation and social services spending choices, and is the component of the Budget by which the government gives force to most of its broad social and economic agenda.

It is established practice to focus on the Budget outcomes of the non-commercial sector for understanding trends in discretionary revenue and spending policies.

2. The Budget Balance

Three years into the Government's Financial Plan, it is apparent that cash balance has been approximately achieved, but not the intended accrual targets.

In May 1998 the South Australian Treasurer announced a four year Financial Plan for the period 1998-99 to 2001-02. Outcomes projections to the end of 2000-01 suggest that the non-commercial sector **cash** targets set out in the Plan have been approximately met. However, there is a significant shortfall against **accrual** targets. To that extent the results are disappointing – especially when one takes into account a quite benign economic climate since the Plan was set.

Ideally an analysis of Budget outcomes to date would consider the accrual results against the targets announced in 1998. In fact, although the Budget papers provide forward estimates on an accruals basis, historic accruals data is incomplete. Instead, therefore, it is necessary to consider historic cash outcomes data. This is regrettable, since the accruals data would be more meaningful, in that they net out the impact of lumpy capital transactions on the cash budget, and include important non-transacted costs and revenues – e.g. depreciation.

A stylised reconciliation of the cash and accrual presentations is as follows:

	Operating result
+	Depreciation
+	Accruing employee entitlements
+	Other accruals
-	Capital expenditures
=	*Underlying cash result*

Table 1 compares cash outcomes to the end of 2000-01 with the projections made when the Financial Plan was announced in May 1998. The comparison relates to the four year period 1997-98 to 2000-01. By using an aggregated period, the analysis is able to avoid discretionary timing effects. (For instance, a decision to defer a SAAMC dividend payment from one year to the next would affect the year by year deficits in a quite arbitrary manner.)

The cash balance has been achieved mainly through lower capital expenditures ...

When the 1998-99 Financial Plan was introduced, an underlying cash surplus of $10 million for the non-commercial sector was projected for the period 1997-98 to 2000-01. A deficit of $27 million is now estimated, implying a deterioration in the outcome of about $37 million.[1] In itself this is a very minor sum, amounting to just 0.1 per cent of current outlays for the period. A reasonable interpretation is that the non-commercial sector was approximately in balance in underlying cash terms over the period 1997-98 to 2000-01.

[1] When the 1998-99 Budget was brought down, the 1997-98 financial year was not complete and it was necessary therefore to estimate outcomes. To the extent that any transactions were delayed from 1997-98 - so-called "slippage" - this would have an impact on 1998-99 results. To represent these effects as deviations from the Budget strategy might be formally correct but would be of little real substance. To abstract from this influence, 1997-98 is included in the assessment period. Therefore, to the extent that the data in the table indicate deviations from estimates and projections at 1998-99 Budget time, they are not attributable to slippage effects. Furthermore, the analysis refers only to the years 1997-98 to 2000-01; 2001-02 financial year estimates are not included.

Table 1
Comparison of Mid Term Outcomes and Initial Projections for the Period 1997-98 to 2000-01[a]

	1998-99 Budget Estimates[b] ($ million)	2001-02 Budget Estimates[c] ($ million)	Variation ($ million)	Variation (Per Cent)
Own source revenues and grants received	25,444	26,280	836	+3.3
less: Current outlays	23,933	24,959	1,026	+4.3
less: Capital outlays	1,817	1,726	-91	-5.0
plus: Provisions	308	288	-20	-6.5
Equals: Surplus (Deficit)[d]	2	-117	-119	
plus: Abnormals	8	90	82	
Equals: Underlying surplus (deficit)[d]	**10**	**-27**	**-37**	
Information item:				
Past service super sinking payments[e]	705	630	-75	-10.6

Notes: [a] totals may not add due to rounding differences.
[b] sum of 1997-98, 1998-99, 1999-2000 and 2000-01 projections.
[c] sum of 1997-98, 1998-99 and 1999-2000 actuals and 2000-01 projections.
[d] a positive result indicates a “surplus”; a negative result indicates a “deficit”.
[e] included as current outlays

Source: Budget papers.

The $27 million deficit contrasts with a deficit of $397 million for the triennium 1994-95 to 1996-97.

Although cash balance has been approximately achieved, it was necessary to reduce sinking payments in respect of past service superannuation liabilities and capital outlays to get there. Payments in respect of past service superannuation liabilities have been $75 million less than was originally anticipated. The amount of these payments is discretionary, and the Government has extended the repayment schedule from 2024 to 2034 so as to accommodate smaller sinking payments.

In addition, capital spending was $91 million less than originally planned.

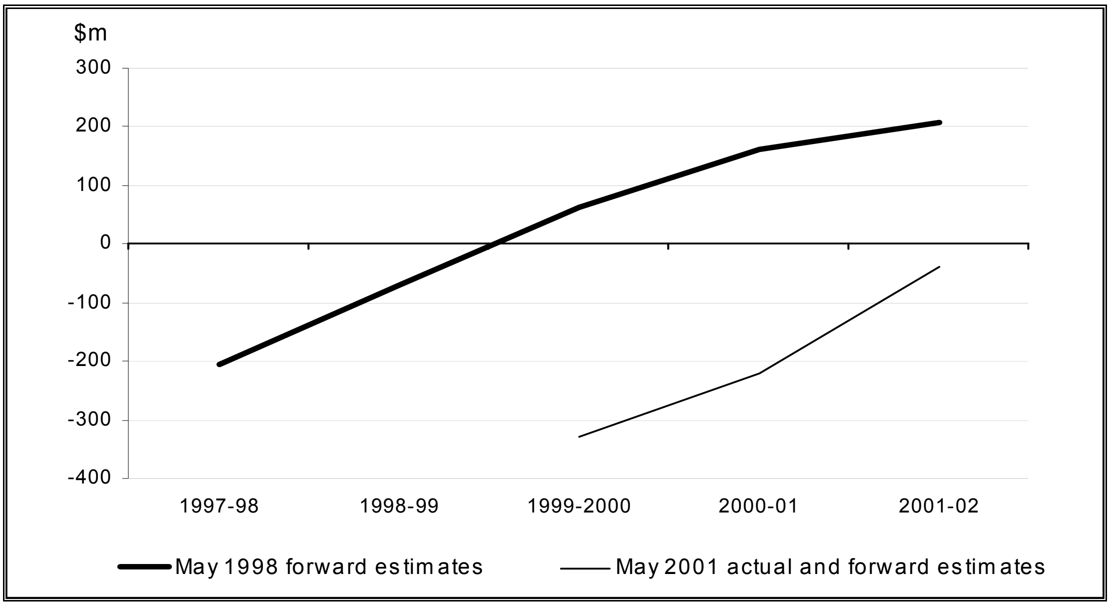
Current spending, on the other hand, was $1,026 million higher than planned, while revenues were up by $836 million.[2]

... but projected accrual surpluses have not been delivered.

The practical implication of this is that the **accrual operating result,** which represents the non-commercial sector’s earnings of resources less its consumption of resources, remains in deficit – well short of the targets set for it three years ago (see Figure 1). For instance, a surplus of $64 million was intended for 1999-2000, while the eventual outcome was a deficit of $330 million. A surplus of $161 million was projected for 2000-01, but a deficit of $221 million is now expected.

[2] The introduction of *A New Tax System* brought about some reductions in own source revenues — in particular the loss of franchise fee replacement revenue which has been treated as an “own revenue and reductions in some gambling taxes.

Figure 1
The Accrual Operating Surplus ($ million)



Source: Budget Statements, various years.

The implication is that the Government has achieved cash balance primarily by restraining capital expenditures. The fact that cash balance has been achieved suggests some stabilisation of the budget position, and to that extent is to be welcomed. However, the continuing accrual deficits mean that the Government has failed to consolidate the State's financial position nearly as much as it originally had intended, in spite of a quite benign economic climate. In 2000-01, for instance, favourable "parameter effects" – such as higher than anticipated Commonwealth grants and mining royalties – contribute $150m to the bottom line (this equates to over 2 per cent of total revenues).

3. The Balance Sheet

Net debt has declined significantly ...

A significant reduction in the State's net debt has been achieved during the course of the financial plan, mainly reflecting electricity lease payments received in 1999-2000.

Net debt for the South Australian whole of government sector has been reduced from $8.1 billion in mid 1997 to $3.3 billion in mid 2001, with $4.9 billion of this debt reduction arising from the privatisation of electricity assets. Over this period the ratio of State net debt to Gross State Product is estimated to have fallen from 21.8 per cent to 7.2 per cent.

In addition to net debt, the other major component of the State's gross liability position is unfunded superannuation liabilities in respect of public employees, which at mid 2001 still amounted to about $3.3 billion.

The aggregate of net debt and unfunded superannuation has fallen from $11.9 billion (32.3 per cent of GDP) in mid 1997 to an estimated $6.6 billion (14.5 per cent of GDP) in mid 2001.

These falls in gross liabilities are attractive at face value, but have been achieved by means of major asset sales. The ordinary activities of the consolidated public sector have not contributed anything to debt reduction – in accrual terms the public sector was in deficit by $89 million in the three financial years to 1999-2000. Furthermore, a deficit of $190 million for the non-financial public sector is expected for 2000-01.

... but there has been no corresponding improvement in the State's net worth.

Because debt reductions have arisen solely from asset sales, there has not been a corresponding improvement in the State's net worth. And, in fact, figures in the Budget papers show that the South Australian public sector's net worth compares relatively poorly with other States (Table 2). In per capita terms South Australia's "net financial worth" is third lowest of all the States. South Australia's "net worth" – a measure that encompasses the value of the general government sector's holdings of physical assets as well as its holdings of financial assets – is lowest of all the States ($8,324 per capita compared with a six State average of $12,668).[3]

South Australia's net worth is low compared with the average across all States ...

Differences between the States are generally more pronounced in terms of "net worth", reflecting the fact that States with low net financial worth generally have low physical asset holdings. An important extension to this observation is that differences in net financial worth are not explained in terms of current day choices about holdings of physical assets – i.e. low net financial worth levels are not generally a product of decisions to hold high levels of physical assets.

The net worth measures raise some interesting questions, for instance:

- How did the differences arise?
- Are the differences important?
- Are the differences likely to disappear?

One source of differences in net worth is past policy decisions about Budget balances – i.e. choices about whether to run surpluses or deficits. A second cause has been differences in the success of investment policies from State to State. This includes both "entrepreneurial" investments – such as state banks, state insurance companies and economic development corporations – and investments in assets which are needed for the delivery of core government services, such as roads, schools, water supply and sewerage infrastructure. The large losses of the State

[3] Net financial worth is the sum of holdings of financial assets such as cash and tradable instruments, plus equity in public sector commercial enterprises, less liabilities such as debt and unfunded superannuation liabilities. Net worth is the sum of net financial worth and non-financial assets (mainly land and fixed assets). Net financial worth is probably the best measure of the "liquid" component of net worth, while net worth itself is an encompassing concept.

Table 2
Per capita Net Worth of General Government Sector ($)

	Net Financial Worth	Non-Financial Assets[b]	Net Worth[b]
New South Wales	3,492[a]	10,054	13,617
Victoria	1,192[a]	7,241	8,469
Queensland	4,335[a]	11,730	16,167
Western Australia	4,615[a]	12,434	16,822
South Australia	1,994[a]	6,318	8,324
Tasmania	980[b]	11,837	12,817
Six States average	3,027[b]	9,641	12,668

Source: a) *Budget Statement*, 2001-02
b) ABS Cats No 5512.0, 3101.0, SACES calculations

Banks of South Australia and Victoria are notable examples of unsuccessful entrepreneurial investments which have reduced the net worth of these States.[4]

A final factor which may to some extent account for these variations is differences in land price trends from between the States. Relatively strong land price trends probably tend to boost net worth, because State Governments have land holdings within their own jurisdictions.

... but this is not a product of privatisation decisions.

In general, changes in net worth have not been a reflection of privatisation decisions. Privatisations affect net worth only when privatisation proceeds differ from a government's own valuation of privatised assets as previously shown on its balance sheet. When valuation differences do become apparent after a sale process, one would need to question the validity of the pre-sale valuation.[5] In the South Australian context, privatisation decisions probably have limited, if any, power to explain the differences apparent in Table 2.

The implication of differential levels of net worth is that if State Governments provide similar levels of public services, then they will almost certainly need to charge different levels of taxes.

Low net worth places South Australia at a fiscal disadvantage to other States ...

For instance, South Australia's low level of net financial worth suggests that the Budget has available to it net income about $90 million per annum *below* the per capita adjusted average of the other States (assuming a 6 per cent rate of return).

4 In Victoria a temporary State Deficit Levy was introduced to claw back some of the slippage in the State's financial position.

5 This is not to rule out that genuine reasons for valuation differences from one owner to another may sometimes exist. Those differences would typically arise because of different owners' varying abilities to run enterprises profitably and because of taxation anomalies. However, pre-sale valuations of government assets are often highly imprecise and cannot necessarily be assumed to represent the true degree of "value adding" that occurs with a privatisation. For instance, historic book values are sometimes used.

The difference is substantially greater when one takes into account holdings of physical assets and assumes that these assets provide services which would otherwise need to be financed from recurrent expenditure. The combination of physical assets and financial assets is aggregate net worth. Assuming returns to net worth of 6 per cent of asset value implies that South Australia would have to raise revenues about $390 million per annum *above* what it would need to raise if per capita net worth was around the average of other States — if a similar level of services it to be provided at average efficiency.[6]

These figures are indicative but rely on some guesswork about rates of returns to financial and physical asset holdings. Precise budgetary impacts cannot be calculated. What can be said with confidence is that the South Australian public sector, because of its low net worth, is at a financial disadvantage to other State Governments. To provide any particular level of government services (at average levels of efficiency), South Australia must tax harder than other States.

... but this cannot be easily rectified ...

There is really no prospect that this disadvantage will disappear in the short to medium term. To reverse the situation, South Australia would need a protracted run of budget surpluses greater than those recorded in other States. To return South Australia to the average, for instance, would require that the South Australian government "save" about $6.5 billion (Victoria $20 billion) over the chosen adjustment period. This would need to be done by higher taxes, lower services, or a combination of both. Queensland could "dissave" about $12.5 billion.

... and while it seems sensible to prevent any further decline, it is not clear that there is necessarily merit in attempting to remove it. The issues involved are complex.

Whether government should attempt to remove this disadvantage however, now that it exists, is a question to which there is not a conclusive answer. The matter relates partly to intergenerational equity. Should higher taxes, or lower services, be put in place in respect of the current generation of taxpayers, so as to rebuild net worth to the advantage of future generations? Or should priority be given to the existing South Australian community, recognising that South Australia's low net worth already implies a need for higher taxes just to provide standard service levels? That is, to what extent should a policy of saving be adopted to restore net worth, given that it constrains the government and the community from potentially justified present day uses of resources?[7]

Also in this context, South Australia's continued relative attractiveness as a place to live will be influenced by the choices that are made today. Low net worth, and the associated need for high taxes to provide standard service levels, will tend to deter people living here.

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6 This analysis assumes that these differences are treated as "policy" factors by the Commonwealth Grants Commission and therefore excluded from the fiscal equalisation process.

7 From the national perspective, to the extent that there is an interest in efficient interstate migration decisions, there is a case for having the States equalise their per capita net worth. Differences in net worth provide incentives to migration that are quite unrelated to the underlying efficiency of jurisdiction choices.

It is likely in addition that low net worth, and the associated financial vulnerability, undermines South Australia as a potential investment location. A stronger balance sheet may be seen as indicating a lesser prospect of tax increases or other threats to investment returns.

It is interesting in this context to note that net worth has a positive correlation with relative economic strength over recent years. Queensland and Western Australia are well above average and New South Wales is a little above average, while Victoria and South Australia are below average. Tasmania is an anomaly on the net worth measure, but fits the pattern on the net financial worth measure.[8] Of course the direction of causation is not clear.

4. The Management Challenge

What are the management options in these circumstances?

The above analysis makes it clear that South Australia's Budget position remains fragile and under stress. What is the least painful way for South Australia to deal with its stressed budgetary situation?

The Financial Plan includes the objectives:

- to meet the service delivery needs of the South Australian community to a standard and at levels of efficiency at least comparable with other States; and
- to ensure the State has a competitive tax regime for business and job creation.

These are worthy objectives, but as noted previously South Australia's balance sheet position is such that if the South Australian Government is to provide average levels of service at average levels of efficiency, it will need have above average levels of taxes.

There is no way around this in the short term.

Government can minimise the financial disadvantage by ensuring efficiency of policy decisions and in service delivery.

What the Government can do, however, is to *minimise* the need for above average taxes, by ensuring efficient production of government services and by ensuring that the mix of services provided is efficient. This involves two tests for government service provision choices.

The *productive efficiency* test requires a consideration of the most efficient way to provide a given service. This decision needs to be taken in an all-encompassing sense; for instance, in out-sourcing the provision of a particular public service it might be justified to select a provider that trains a substantial number of apprentices, even if that provider charged more to the government to provide those services than some other provider that did not train apprentices.

8 It would not be surprising to see low per capita net worth in regions with strong population growth because with strongly growing populations the aggregate net worth would be diluted across a larger population. But, in fact, this appears not to happen.

The importance of a well framed service definition can hardly be overstated – use of a narrow or excessively short term set of indicators may lead to a mistaken choice. The choices about productive efficiency may involve choices of production technologies, or choices of suppliers – e.g. in-house provision or contracting out. To maximise productive efficiency, decisions need to be taken on their merits, on a case by case basis. The assessments of efficiency need to be from a whole community point of view, taking into account factors such as the costs of worker displacement.

The *allocative efficiency* test requires a consideration of what is the right mix of services provided by government to the community. The mix of services provided will be allocatively efficient if the recipients of the services value them at as least as much as the alternative of a cash transfer equal to the costs of provision. This may not be the case when governments bundle together distributive decisions and service provision decisions. Bundling creates an environment in which service delivery becomes a surrogate for the achievement of particular distributive outcomes, but is actually an inefficient means of achieving them.[9]

The separation of distributive outcomes and service provision is straightforward in principle, and often (although not always) feasible in practice. For instance, in recent years the identification of "community services obligation" payments for non-viable commercial activities has increased the transparency of bundled distributive and service level decisions.

There may also be scope to improve the institutional structure to support better decision making. For instance, decisions about service levels are more likely to be taken according to their costs and benefits if they are devolved to lower level decision units in which there is a better correspondence between payees and beneficiaries. At the margin, spending by those decision units would have a dollar for dollar impact on the taxes or charges to their constituents.[10] Obviously the degree of devolution needs to be determined cognisant of the costs of the low level decision units.

For instance, more infrastructure could be charged to local beneficiaries according to local costs. This would involve moving away from state-wide pricing policies, with prices being set instead at the local level according to service level choices. It would be quite consistent with the operation of such a model for government to continue to provide financial support to those decentralised decision units, but not to tie

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9 The approach taken here draws on Stephen Coate (2000) 'An Efficiency Approach to the Evaluation of Policy Changes', *Economic Journal,* **110** (April), pp. 437-55. An example might be the provision of public infrastructure on a non-charged basis where the infrastructure costs more than the benefits to intended beneficiaries. Because beneficiaries pay a zero cost, the decision is attractive to them regardless of true costs, although it would not be if they paid true costs.

10 Decision processes could be reinforced by empowering the beneficiaries, who are also the payers, to accept or reject spending proposals — for instance by means of ballots. These could be at a local government level for local government type services, or at the level of small groupings of collective beneficiaries for infrastructure provided by other organisations.

financial support to the level of service chosen. To a significant degree local government operates on this basis.

5. The Outlook

The Treasurer continues to forecast improved fiscal trends ...

The Treasurer forecasts a steady improvement in the accrual operating result over the next few years and, from 2002-03, a sequence of small cash surpluses. However, as discussed previously, forward estimates like this have been made before and not delivered.

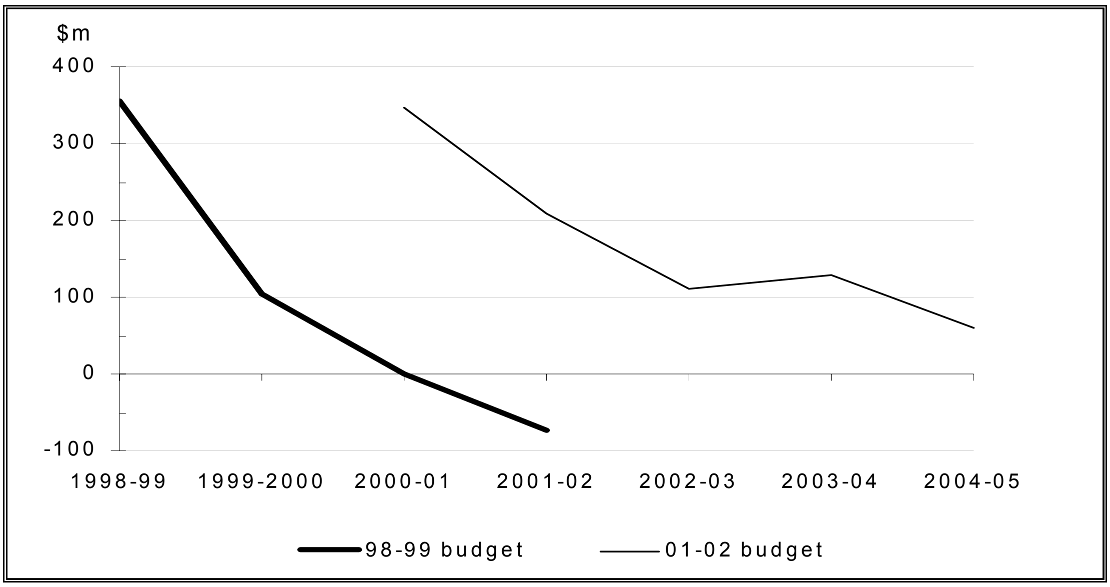
The forward estimates imply a continued net lending requirement, and this is at odds with the Financial Plan's target. The Plan intended that the operating surplus should be large enough to cover capital investment net of depreciation.

Figure 2 shows forward estimates of the net lending requirement at the beginning of the Plan and from this year's Budget. At the beginning of the Plan, it was intended that the net lending requirement be reduced from $356 million in 1998-99 to zero by 2000-01. In the event, the net lending requirement for 2000-01 is estimated to have been $346 million. A gradual improvement is predicted, but the no-net-lending target is now not even on the horizon of the forward estimates period.

... but the bottom line is that the South Australian Budget is likely to remain under stress into the foreseeable future.

So long as the deficit on the operating result continues, the State's net asset position is unlikely to show a systematic improvement. Even with the projected moderate surpluses, any improvement will be very gradual. And it is hard, on the basis of past performance in meeting targets, to be confident that the surpluses forecast for the future will be achieved. In fact the current state of approximate cash balance seems likely to continue unless an argument emerges that is convincing enough to create a multi-partisan view that a significant surplus is desirable.

Figure 2
Net Lending Requirement ($ million)



Source: Budget Statements, various years.