Economic Issues

No. 13

The 2004-05 South Australian Budget

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Director's Note

Welcome to the thirteenth issue of a series published by the South Australian Centre for Economic Studies as part of its Corporate Membership Program. The scope of 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.

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July 2004ı -1.(uthoe)65('s NA

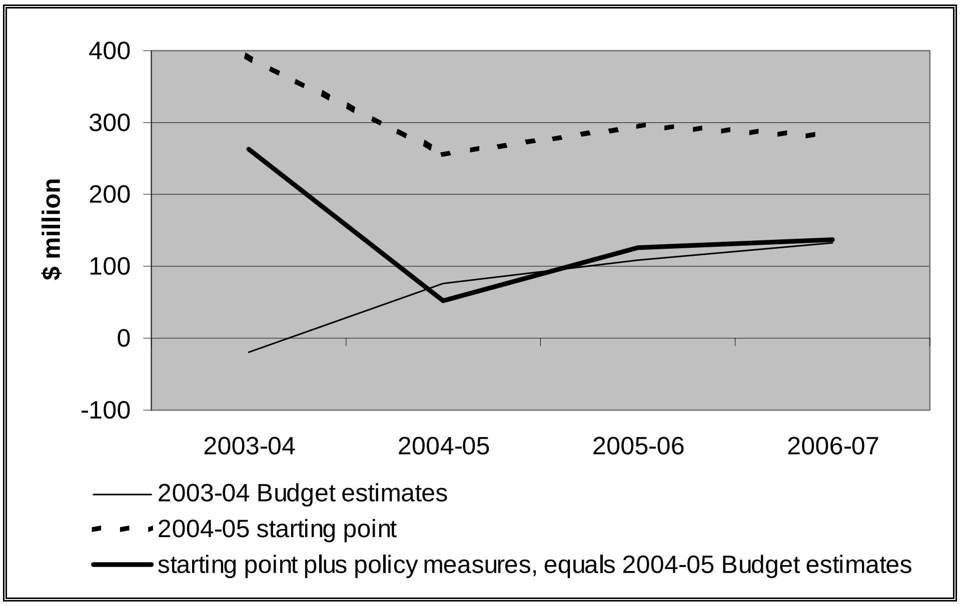
necessarily a bad thing, as it may reflect more effective culling of projects with weak justification.

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.

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

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.

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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 ar(exu3-ed)ntsir0 ns and(peg)9.2(e)73te

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

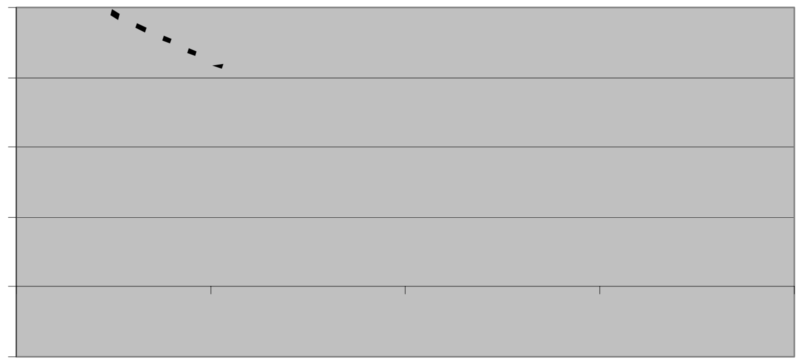


Figure 3
Estimates of conveyance duties

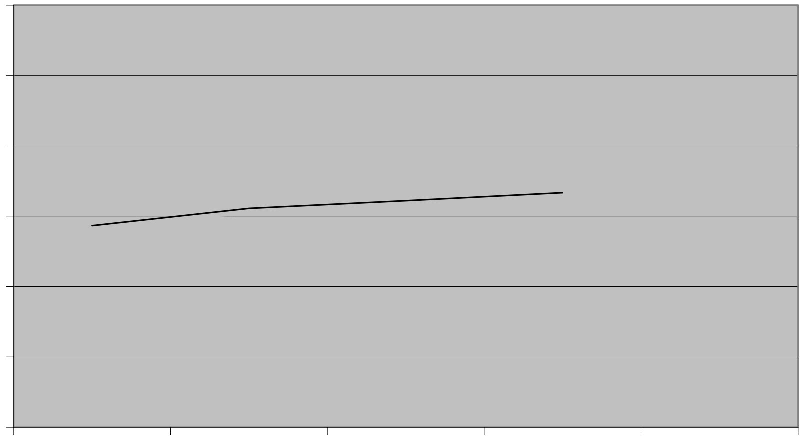


Figure 4 shows that net cash flows were in substantial surplus in the late 1980s and 1990-91, but that those surpluses disappeared by 1991-92 due to a much weaker economy and emergence of the State Bank losses. Although there was a temporary improvement in 1992-93, relating partly to emergency support 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

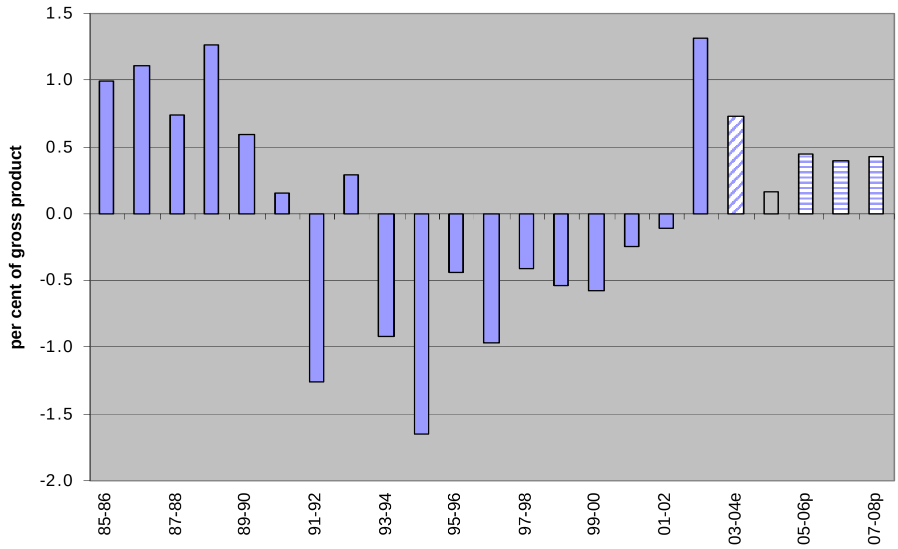
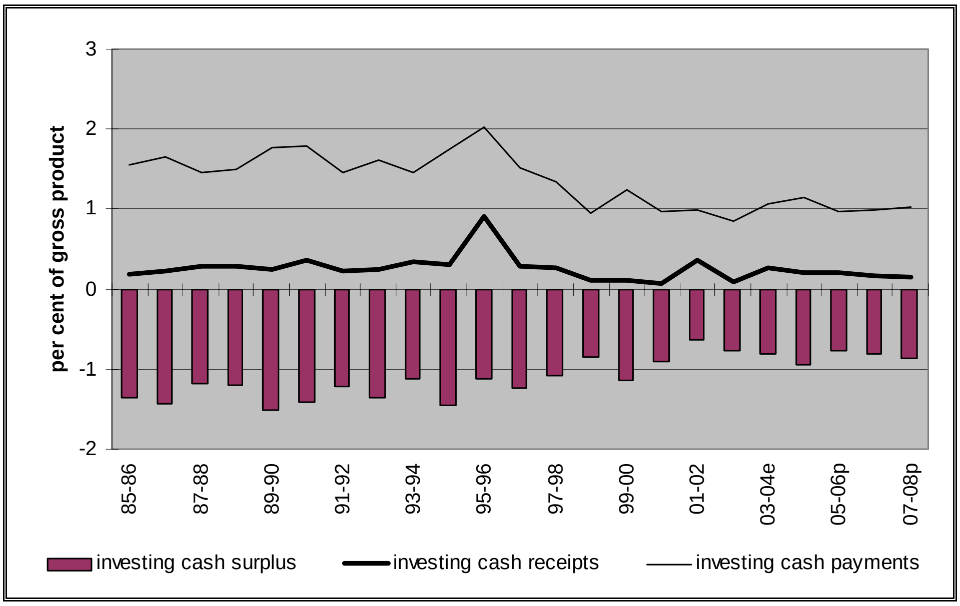


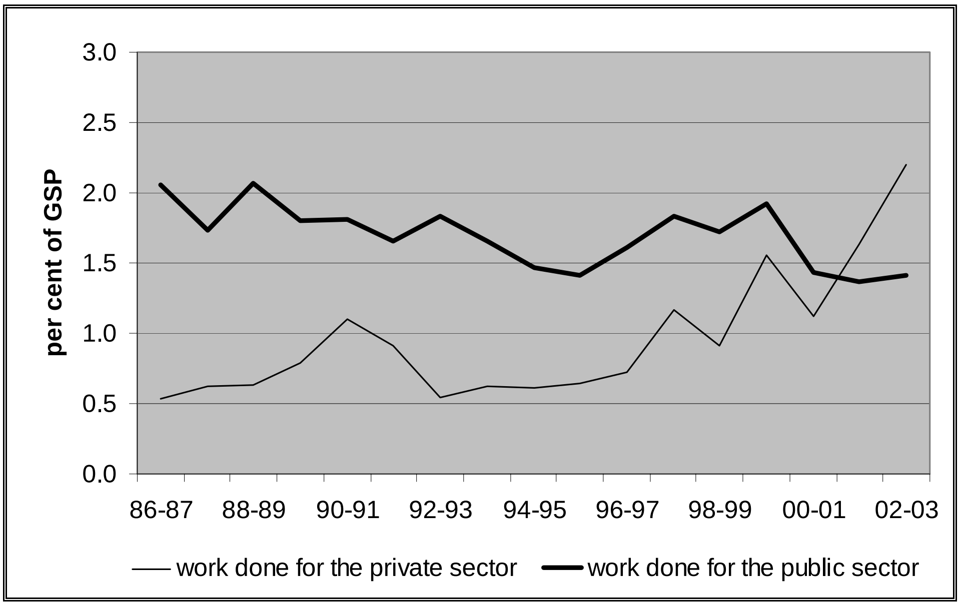
Figure 6
Investment cash flows



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.

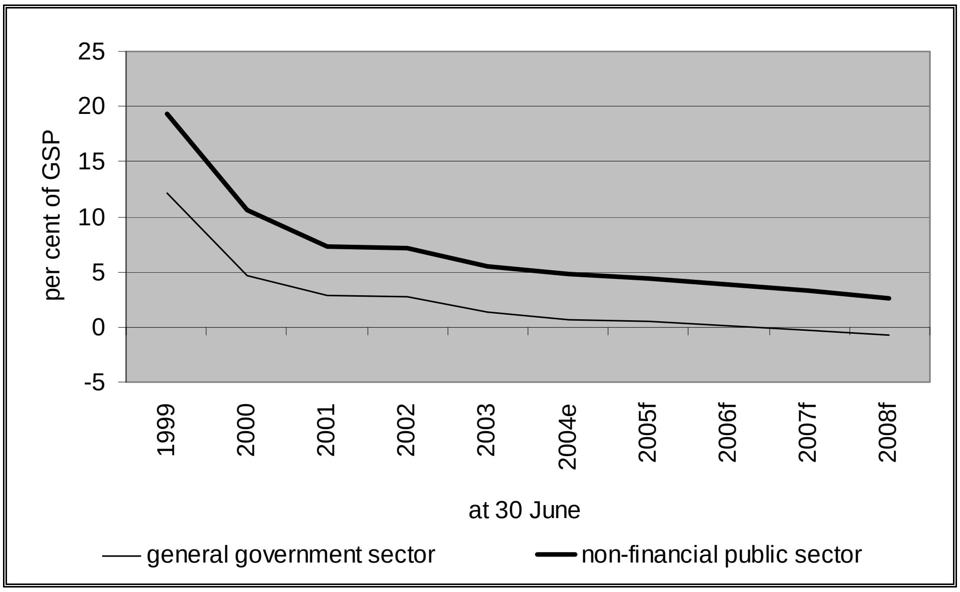
Figure 7
Engineering construction



Source: ABS (Cat. No. 5220.0) and (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]

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, 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.

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 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.

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, 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.