Economic Issues

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The 2001-02 South Australian Budget

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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

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

2. The Budget Balance

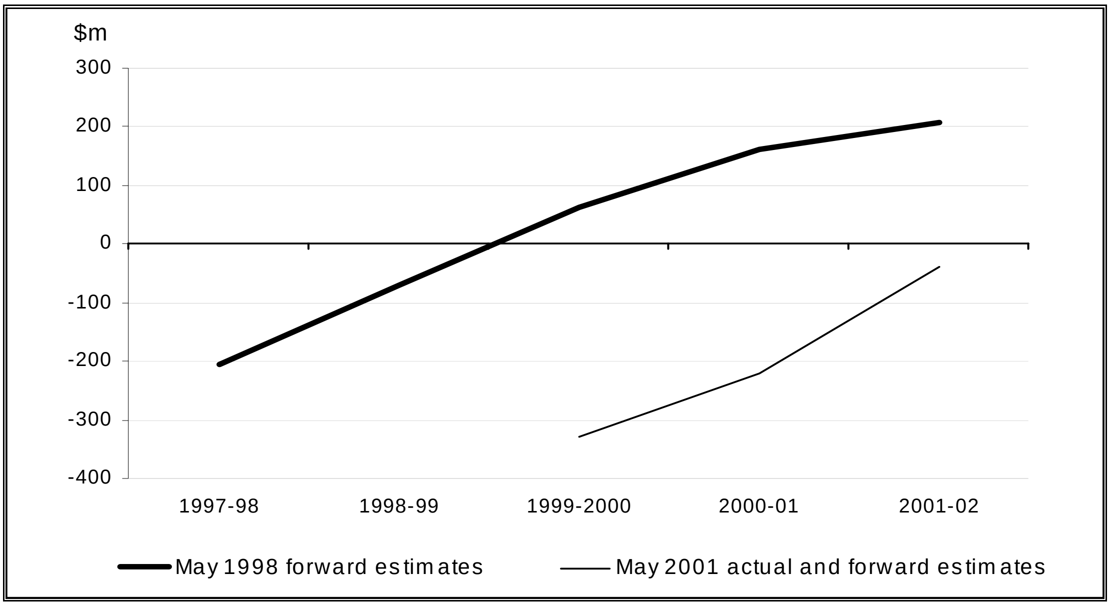
Three years into the Government's Financial Plan, it is apparent that cash balance has been approximately achieved, but not the intended accrual targets.

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

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

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

Net debt has declined significantly ...

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

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

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

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]

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

... 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.

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

[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 e965.618509 Tc