Agenda paper: 2016-27

Purpose: Information

Inquiry: 2017 Update

Prepared for meeting of: 27 July 2016

STATE BUDGET DEVELOPMENTS 2016-17

REASON

To inform the Commission about what States expect their budgetary and fiscal positions to be in the 2016-17 financial year.

ISSUES

- Economic and budget outlook
- Main spending and revenue initiatives
- Expected GST shares in the forward estimates
- State comments on the HFE system and the work of the Commission.

RECOMMENDATIONS

- The Commission note the paper.

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References

State Budget documents 2016-17

Confidentiality statement

This document does not contain confidential material.

Statement provided by Catherine Hull

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INTRODUCTION

1 States have recently brought down their 2016-17 budgets. This paper provides a high level summary of State expectations and intentions for that year and over the forward estimates period. While 2016-17 is not the application year for the 2017 Update, this information will provide some guidance to the Commission on how States see their budgetary and fiscal positions changing in the future.

2 The paper provides information on:

- State economic and budget outlooks
- main spending and revenue initiatives
- State expectations in relation to their GST shares
- information on how States regard the HFE system and outcomes.

STATE ECONOMIC AND BUDGET OUTLOOK 2016-17

Economic growth and its drivers

3 All States are expecting positive but modest economic growth in 2016-17. Queensland expects growth of 4%, New South Wales and Victoria are expecting about 3%, South Australia, Tasmania and the ACT about 2% and Western Australia and the Northern Territory about 1%.

- Gross State Product (GSP) growth in New South Wales is forecast to be 3 per cent in 2016-17, up from 2¾% in 2015-16. Household consumption, dwelling construction and public investment, especially in urban rail, are expected to continue to make strong contributions to growth. Wages are forecast to grow by 2.5%.
- GSP growth in Victoria is expected to be 3%, up from 2.5% in 2015-16. Household consumption and business investment are expected to remain above trend, but dwelling investment is expected to ease, with a levelling of house prices. Employment and population are both expected to grow strongly. Wages growth is expected to pick-up in 2016-17 also.
- Following a weak result in 2014-15, the Queensland economy is expected to rebound to a growth of 4% in 2016-17, with Queensland expecting the strongest economic growth of all States over the budget period. The rebound is underpinned by a surge in overseas exports, as liquefied natural gas (LNG) production ramps up. Sectors that previously suffered during the resources boom are now strengthening. In particular, low interest rates, underpinned by strong investor demand, are supporting housing construction, particularly in medium-to-high density housing in the south-east corner of the State. The lower $A is expected to boost tourism and education exports. In contrast to

exports, the domestic economy is expected to remain subdued, with slow wages growth, subdued population growth and soft labour market conditions.

- The Western Australian economy is experiencing a period of below trend growth, following an unprecedented expansion underpinned by business investment that lasted more than a decade. GSP is expected to grow by 1.25% in 2016-17, gradually recovering to reach 3% by 2019-20. Growth is underpinned by a pick-up in consumer spending and an eventual return to modest growth in business investment, as well as the continued expansion of LNG exports.
- South Australia forecasts GSP to be steady at 2% in real terms in 2016-17, then rising to 2.25% across the forward estimates. This is despite the challenges the State will face over the next few years from the significant structural adjustment task when car manufacturing ceases in 2017 and from the effect of falling commodity prices on resource and related industries. Private new business investment remains subdued, declining by 11% in the year to March quarter 2016. Mineral and petroleum exploration spending has declined from recent highs, falling by 73% in nominal terms in the year to March quarter 2016. The Government's significant infrastructure program will support construction industry activity and jobs, as will the Dept of Defence's new continuous shipbuilding program from 2017. Employment is forecast to grow by 0.75% in 2016-17 (up from 0.5% in 2015-16), then by 1% across the forward estimates.
- Tasmania expects its economic growth to fall from 2.5 % in 2015-16 and 2016-17 to 2% by 2017-18. Hobart is experiencing a construction boom, the tourism industry is buoyant and the State's business confidence is at a national-high, with international exports growing. However, the January 2016 bushfires cost $31 million, and record-low rainfall combined with a broken Bass Strait electricity cable created an energy supply crisis, costing more than $100 million. Employment growth is flat. Population growth is at its long term trend rate of 0.6%.
- The ACT is expecting its GSP to grow by 2% in 2015-16, 2.25% in 2016-17 and 2.5% from 2017-18 onwards. This is due to the end of the Commonwealth Government's hiring freeze on 1 July 2015, the lower Australian dollar, low interest rates and the ACT's significant infrastructure investments. Employment is expected to grow between 1% to 1.5% annually from 2015-16 till 2019-20. The unemployment rate in April 2016 is 4.1%. Population is anticipated to grow by 1.5% from 2015-16 onwards.
- The Northern Territory is expecting its economic growth to fall from 10.5% in 2014-15 to 1.5% in 2016-17, before improving from 2017-18. This is largely due to a decline in private sector investment related to the Ichthys LNG project. Public sector investment, including Commonwealth defence capital works, is expected to partially offset the decline in private sector investment. Employment growth was negative in 2014-15 but this is expected to improve in 2015-16 then soften over the forward estimates due to a slowdown in

engineering and dwelling construction activity. Population growth in 2015-16 is lower than previous years and is expected to remain below historical averages in 2016 and 2017 (at 0.1%).

Net operating balances and net debt

4 While New South Wales, Victoria, Queensland and South Australia are predicting budget surpluses in 2016-17 and over the forward estimates, Western Australia and the ACT are predicting deficits over the period. Tasmania and the Northern Territory expect surpluses in 2016-17 but deficits after that. Net debt is expected to increase in all States but Queensland and Tasmania over the forward estimates period. The level of net debt appears likely to remain above average in Queensland, Western Australia, the ACT and the Northern Territory.

- New South Wales is forecasting a budget surplus of $3.7 billion in 2016-17, with an average of $2 billion in the forward years. Revenue (4.4%) is expected to grow faster than expenses (4.2%) in 2016-17. However, net debt is expected to increase to $7.5 billion in 2016-17 and is projected to increase to $24.0 billion (3.7 per cent of GSP) by the end of the forward estimates. This is due to increased capital expenditure.
- Victoria is predicting a budget surplus of $2.9m in 2016-17, with revenue (3.4%) growing faster than expenses (3.3%). Surpluses are expected in the out years. Net debt is forecast to decrease to $18.6 billion (4.7% of GSP) in 2016-17, increase in 2017-18 and 2018-19 to $22.3 billion, then reduce in 2019-20.
- Queensland expects to run operating surpluses in 2016-17 ($152m) and the out-years (peaking at $1.2b in 2017-18). The Queensland budget outlines a strategy to lower debt, provide additional funds for investment without the sale of government owned corporations, without increases in taxes and without cuts to services. The strategy involves:
  - surplus repatriation from defined benefit superannuation scheme
  - storing short term cash balances within the general government sector rather than with government owned corporations
  - regearing government owned corporations.

  Net debt peaked at $43.1 billion in 2014-15 and is expected to reduce to $38.7 billion in 2019-20.
- Western Australia is forecasting a deficit in 2016-17, reflecting a projected shortfall between revenue (of $25.7 billion) and recurrent spending (of $29.6 billion). General government revenue is expected to decline in 2016-17 for the third year in a row, with mining royalties at their lowest level in this year (although still about $4 billion per annum over the forward estimates). Operating deficits are said to be 'unavoidable in the near term'. Net debt at 30 June 2016 is estimated to be $27.9 billion and, with projected operating deficits combined with substantial infrastructure investment, is forecast to

increase to $40.2 billion by the end of 2019-20. This result does not include anticipated proceeds from Western Australia's asset sales program, with which it intends to materially pay down debt and finance new infrastructure projects.

- South Australia expects a budget surplus of $254 million in 2016-17 which is expected to increase significantly over the forward estimates. Real growth in revenue is expected to be 3.8% and real growth in expenses 3.9%. Both are expected to slow significantly over the forward estimates. Net debt is expected to increase in 2016-17 by 57.8% from its 2015-16 level (to $6.2 billion), principally due to the recognition of the $2.8 billion finance lease for the new Royal Adelaide Hospital. This level is not expected to change much over the forward estimates.
- Tasmania expects a budget surplus of $77 million in 2016-17, partly the result of TT-line (Bass Strait Ferry) contributing $80 m over the next two years to a special ship replacement fund. However, deficits are expected in the following years largely due to Tasmania's reducing GST share. Net debt is expected to rise to $0.3 billion in 2016-17 and to fall in each of the out years, reaching $0.1 billion by 2019-20.
- The ACT has forecast an operating deficit of $94.3 million in 2016-17, a deficit in 2017-18, and return to balance in 2018-19 and 2019-20. Net debt is expected to increase by 40% over the period 2015-16 to 2019-20 from $1.8 billion to $2.6 billion.
- The Northern Territory expects a budget surplus in 2016-17 but deficits in 2017-18 and 2018-19 due to reduced GST revenue, lower taxation revenue and a moderation of economic growth. A return to surplus is expected in 2019-20. A reduction in public sector net debt in 2015-16 is expected due to the leasing of the Port of Darwin; however, net debt is expected to increase again over the forward estimates (from $2 to $3.1 billion) to fund substantial infrastructure investment.

MAIN SPENDING AND REVENUE INITIATIVES

5 Most States are planning to increase spending on education, health, welfare (domestic violence), custodial services, police and transport. They are also focusing on programs to provide a boost to their economies (to support industry and employment). As well there is a heavy emphasis on capital expenditure on infrastructure – mainly on schools, health facilities, housing and transport (road and rail).

6 The main revenue initiatives relate to increases in payroll tax thresholds (Vic, WA, ACT) and increases in taxes on foreign owners of property (NSW, Vic, Qld). Other initiatives include the following:

- SA abolished stamp duty on non-real property from June 2015 and is phasing in the abolition of stamp duty on non-residential real property transfers. It has introduced a 15% tax on net wagering revenue received from persons located in South Australia by all Australian based wagering operations from 2017-18.
- The ACT has abolished insurance tax and introduced a Safer Families Levy of $30 per annum (applied to all residential and rural properties) from 1 July 2016 to support family violence prevention initiatives. None of these changes will affect the 2017 Update.

STATE 2016-17 BUDGET FORWARD YEAR GST ESTIMATES

7 Table 1 below shows the estimated GST revenue to be received by each State over the period 2015-16 to 2019-20, as included in State 2016-17 budget papers. The majority of States apply their own modelling to derive these estimates, rather than use the projections included in the Commonwealth 2016-17 budget (which explicitly project constant relativities to future population and pool estimates). The States all use slightly different models, as shown by the aggregated State totals not matching the Commonwealth's estimates of GST revenue, particularly in the out years.

Table 1 State GST revenue estimates, 2016-17 budgets

	2015-16 (a)	2016-17	2017-18	2018-19	2019-20
	$m	$m	$m	$m	$m
NSW	17 619	17 634	17 644	17 768	18 243
Vic	13 032	13 885	14 609	15 770	16 534
Qld	13 122	14 297	14 927	14 825	15 189
WA	1 886	2 035	2 906	4 698	6 003
SA	5573	6101	6424	6479	6574
Tas	2 246	2 299	2 332	2 336	2 394
ACT	1 049	1 154	1 216	1 279	1 335
NT	3 274	3 263	3 306	3 474	3 698
Total	57 801	60 668	63 364	66 629	69 969
Commonwealth	57 792	60 660	63 940	67 350	70 370

(a) Includes 2014-15 balancing adjustment of $342 million for all States except Tasmania and the Northern Territory.

(b) Tasmania's estimates for 2015-16 and 2016-17 are based upon its previous budget and the CGC U2016 Report respectively, not the Commonwealth BP3.

Source: Australian Government 2016-17 budget paper no. 3; State 2016-17 budget papers.

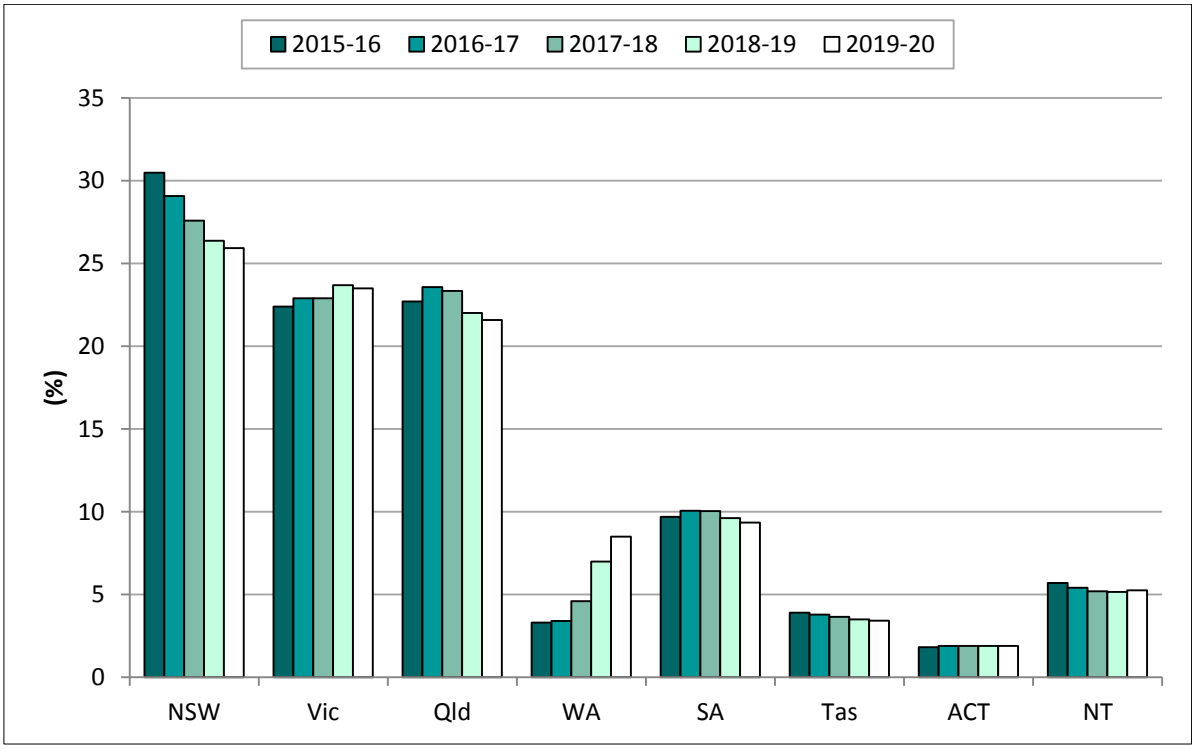
8 Figure 1 shows the GST estimates as State GST shares. The changing shares reflect the expected changes in State fiscal circumstances over time as captured in each State's relativity models. While not all States show relativity estimates in their budget papers, it is their modelled relativities which underlie their GST revenue estimates.

9 Changes in each State's estimated share of GST revenue are explained in their budget papers as follows:

- New South Wales' GST relativity is expected to decline to historic lows by 2019-20, reflecting stronger than average growth in its transfer duty revenue and weaker Western Australian royalty revenues.
- Victoria's GST relativity is expected to increase, in part as a result of it having above average population growth, leading to an increased need to invest in new infrastructure. However, Victoria's robust economic and revenue growth, relative to some States, will place some offsetting downside pressure on Victoria's relativity by the end of the forward estimates.
- Queensland's historically high 2013-14 assessment year relativity will continue to affect its GST share until 2017-18. However the factors driving the 2013-14 result are short term. Net expenses for natural disaster relief and recovery arrangements (NDRRA) are expected to remain low, and Western Australia's mining revenue has been adversely affected by a fall in iron ore prices. Queensland's relativity can be expected to move closer to 1.0 once the short-term effects of 2013-14 factors have worked through the equalisation system.
- Western Australia's relativity is forecast to rise to 0.76 by 2019-20, following the lagged response to the sharp reduction in iron ore royalties and North West Shelf grants in recent years, along with weak growth in taxes compared to other States. Staff have tested the plausibility of such a large increase in Western Australia's relativity and found such a result is not completely implausible. It is based on the effects of steady (or falling) mining revenues in nominal terms being more than offset by growth in the pool of around 6% per annum (so that the redistribution due to mining becomes a much smaller share of the pool).
- South Australia notes it expects its GST relativity to fall because of increases in payments for specific purposes (particularly for road and rail infrastructure), the decline in mining revenue in Western Australia and the new data flowing into the wage cost assessment.
- Tasmania's relativities are expected to return to trend levels across the budget years, from a high in 2015-16 resulting from the additional royalty revenue generated in Western Australia and the other mining States during the mining boom.
- The ACT GST revenue estimates have been taken directly from the Commonwealth (which holds the most recent relativity constant across the budget years). That is, the ACT does not model changes to its relativity for the purposes of estimating future GST revenue.
- The Northern Territory observes that generally the four large States have a greater influence that the smaller States on the revenue and expenditure against which all States' fiscal capacities are assessed, so that consequently it is difficult to forecast its relativity movements. As a result, the Northern Territory

has adopted a conservative approach to estimating its relativity, continuing the recent downward trajectory in its recommended relativities.

Figure 1 State estimated GST revenue shares, 2015-16 to 2019-20



Source: Australian Government 2016-17 budget paper no. 3; State 2016-17 budget papers.

STATE COMMENTS ON THE HFE SYSTEM AND THE COMMISSION'S WORK

New South Wales

10 As noted above, New South Wales expects substantial falls in its GST:

- in 2016-17, GST revenues are expected to be $850.5 million lower, compared to the distribution of funding in 2015-16, following the reduction in the State's GST relativity.
- reductions of similar magnitude are expected in 2017-18 and 2018-19 as strong growth in NSW transfer duty revenue and large falls in Western Australia's mining royalty revenue feed into the Commonwealth Grants Commission's calculations.

11 It notes in its 2015-16 budget papers that the NSW Government has long called for reform of the current HFE system. It refers to its submissions to the CGC's 2015 Methodology Review which argued that 'the current system of HFE is complex, non-

transparent, subject to decisions based on the CGC's judgment and discouraged State initiative and tax reform'.

12 New South Wales also notes that it continues to believe that the current system of HFE should be replaced by a distribution based on an equal per capita share of the GST pool, with the Australian Government providing separate equalising payments to the fiscally weaker States.

Victoria

13 Victoria notes in its 2016-17 budget papers that GST is Victoria's single largest revenue source. It welcomes a number of important adjustments to the formula for distributing GST revenue between States made by the Commonwealth Grants Commission in its 2015 Methodology Review - the Commission's recognition of the additional costs of providing critical infrastructure in urban centres such as Melbourne, and its more consistent treatment of Commonwealth funding for road and rail projects. It says these changes represent 'a substantial improvement to the model for allocating GST revenue'.

14 However, because 'Victorians continue to subsidise other States', in the longer term Victoria supports re-examining the system to ensure that it is more transparent, simple and fair for all jurisdictions.[1]

Queensland

15 The Queensland budget has 5 pages describing its GST share, largely repeated from the 2015-16 budget. This is a detailed explanation of both the principles of HFE as well as an assessment of the impact of averaging and a lag on Queensland's share. The section is articulate but bland. The primary implication is that:

> In the longer–term, Queensland's fiscal capacity can be expected to be nearer to the average of states (that is, a relativity of 1.0). However, many of the factors impacting Queensland's relativity are volatile, such as transfer duty, mining revenue, natural disaster relief and other Australian Government payments.
>
> The significant impact of volatile factors means that while Queensland's relativity may be nearer to the average of all states in the longer–term, on an annual basis it will continue to fluctuate, and be above 1.0 in some years and below in others.

[1] Victorian Budget paper No2 2016-17, p18.

Western Australia

16 Western Australia provides a factual statement about the process. It notes the following.

> After reaching a record low of 30.0% in 2015-16, Western Australia's GST 'relativity' has remained virtually unchanged in 2016-17, at 30.3%. This reflects the substantial time lags used in the Commonwealth Grants Commission's assessments.
>
> The above factors have combined to contribute to a 'perfect storm' for Western Australia's revenue over the three years to 2016-17. These circumstances have led the Commonwealth Government to provide GST 'top-up' payments of $499 million in 2014-15 and $490 million in 2015-16.
>
> If all time lags were removed from the CGC process, Western Australia's GST grants would be $7.4 billion higher across the four years from 2016-17 to 2019-20 ($3.2 billion higher in 2016-17).
>
> The time lags also mean that the GST losses in 2016-17 associated with Western Australia's historic royalty revenues are expected to exceed Western Australia's 2016-17 royalty collections by around $900 million.
>
> As the reduced royalties and other changes in the years 2014-15 to 2017-18 flow (with a time lag) into the relativity calculations, Western Australia's relativity is expected to improve. However, although projected to reach 75.9% in 2019-20, this still remains below the lowest relativity faced by any other State except for Victoria in 1992-93 and prior to 1950-51. Western Australia's relativity during the period 2012-13 to 2018-19 is expected to remain lower than ever faced by another State since 1942-43.[2]

South Australia

17 The budget contains a page and a half describing how the State's GST share is derived and the Commission's recommendations for 2016-17. It also contains a description of the changes to the wages assessment in the 2016 Update. It notes it expects its GST relativity to fall and identifies the reasons.

18 South Australia has replicated the Commission's ratios of actual to assessed tax revenue (formerly assessed revenue raising effort ratios), with adjustments to remove the land tax paid by the South Australian Housing Trust, to demonstrate that it is a relatively low taxing State.

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[2] Western Australia budget Paper No 3 2016-17, p84.

Tasmania

19 Tasmania strongly supports retaining the principles of HFE. It says the following.

> HFE is a cornerstone of the success of Australian society. It has served Australia well by responding and adapting to changing state circumstances, and allowing for the mobility of labour and capital across the national economy. Without HFE, certain states within the Federation, including Tasmania, would be significantly disadvantaged due to unavoidable differences in fiscal capacities and the cost of providing government services, given factors such as the composition of the State's population.
>
> Except for Western Australia, all states and territories supported the Australian Government adopting the Commission's independent recommendations for 2015-16 and were strongly opposed to any 'one-off' changes to address the issue of Western Australia's declining mining royalties through the GST distribution system. Tasmania argued that HFE is a fundamental characteristic of the success of Australia's Federation, and that using the GST distribution to address an issue for a specific state would materially undermine the fabric of the HFE system. [3]

ACT

20 In its 2016-17 budget documents, the ACT commented only on major issues arising in the CGC 2016 Update.

- The ACT noted the wage cost assessment was favourable to the ACT and distributed $76 million, or $191 per capita, above an equal per capita share in GST to the ACT in 2016-17.
- The reclassification of the Majura Parkway as a National network road made as a result of arguments presented by the ACT.

Northern Territory

21 In its 2016-17 budget documents, the Northern Territory sets out the HFE process in a factual manner and notes the outcome of the 2016 Update, It notes that GST revenue is its largest revenue source and that it has reduced. However, it offers no criticism of the Commission's work. It uses much of our data such as revenue effort ratios, in other parts of the budget documents.[4]

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[3] Tasmanian Budget Paper No 1 2015-16, pp 91, 92.

[4] Northern Territory Budget Paper No 2 2016-17, p10, 23.

CONCLUSIONS

22 While the Western Australian and Northern Territory economies are facing tough times because of falling revenues, the New South Wales, Victorian and Queensland economies are expected to strengthen, with their revenues growing. As a result, the later three States are expected to run budget surpluses from 2016-17 and over the forward estimates. Western Australia, Tasmania, the ACT and the Northern Territory are mostly predicting deficits over the period.

23 Net debt is expected to increase over the forward estimates period in all States but Queensland and Tasmania. The level of net debt per capita appears likely to remain relatively high in Western Australia ($15), the Northern Territory ($12), Queensland ($8) and the ACT ($7) compared with that of New South Wales and Victoria at about $3 per capita.

24 Spending in all States appears to be focused on health, education and supporting industry and jobs growth, with also a heavy emphasis on investment in infrastructure (again health and education and roads and rail). Revenue changes appear minor.

25 Interestingly, most States seem to have a reasonable understanding of how the changes in their fiscal circumstances will influence their GST shares.

26 Their positions in relation to the HFE system (supporters or detractors) appear to reflect the likely GST outcomes for their own States into the future.