Agenda paper: 2017-32

Purpose: Information

Inquiry: 2018 Update

Prepared for meeting of: 20 September 2017

STATE BUDGET DEVELOPMENTS 2017-18

REASON

To inform the Commission about what States expect their budgetary and fiscal positions to be in the 2017-18 financial year.

ISSUES

- Economic and budget outlook
- Main spending and revenue initiatives
- Expected GST shares in the forward estimates
- State comments on federal financial relations.

RECOMMENDATIONS

- The Commission note the paper.

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References

State Budget documents 2017-18

Confidentiality statement

This document does not contain confidential material.

Statement provided by Catherine Hull.

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INTRODUCTION

1 All States have now brought down their 2017-18 budgets. This paper provides a high level summary of State expectations and intentions for that year and over the forward estimates period. While 2017-18 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 going forward.

2 The paper provides information on:

- State economic and budget outlooks
- main spending and revenue initiatives
- State expectations in relation to their GST shares
- State comments on federal financial relations.

STATE ECONOMIC AND BUDGET OUTLOOK 2017-18

Economic growth and its drivers

3 All States are expecting positive but modest economic growth in 2017-18. New South Wales, Victoria and Western Australia are expecting about 3% growth in Gross State Product (GSP), Queensland and the ACT, 2.75%, South Australia and Tasmania about 2-2.5% and the Northern Territory about 1%.

- New South Wales' GSP is forecast to grow by 3% in 2017-18 and 2.75% for the following two years. The forecast reflects growing export demand, low interest rates, strong population growth and continued investment in public infrastructure. Wages are forecast to grow by 2%, moderated by excess labour capacity, largely in the rest of Australia, with above trend migration into New South Wales expected to slow any decline in the unemployment rate.
- GSP growth in Victoria is expected to be 3% in 2017-18, down from 3.3% in 2016-17. Household consumption, business, dwelling and government investment and exports continue to contribute to strong growth. Population growth is expected to slow but employment is expected to continue to grow. Wages are increasing modestly.
- The Queensland economy is expected to grow 2.75% in 2017-18 and strengthen further in later years. Growth has been subdued due to Cyclone Debbie but is expected to be driven by a renewed mining boom, including Adani, conditional on sustained commodity prices as well as tourism and education exports. Dwelling construction will peak in 2016-17.
- Western Australia's economy is forecast to grow 3.0% in 2017-18, after an estimated record low of 0.25% in 2016-17. The economy is showing signs of recovery following a prolonged slowdown in economic growth over the past

five years. Growth is underpinned by modest growth in business investment, as well as the continued expansion of liquefied natural gas (LNG), iron ore and gold exports. Employment is expected to grow 1.5% across a range of industries.

- South Australia expects GSP to grow by 2.25% per annum from 2017-18 through to 2020-21. Employment growth is expected to be 1% from 2017-18 (down slightly from 1.25% in 2016-17). The lower Australian dollar is expected to continue to support economic activity in the trade-exposed sectors of the South Australian economy, including tourism, international education, and premium food and wine. The new shipbuilding program centred near Port Adelaide will support the development of advanced manufacturing in the State and will contribute to job opportunities in 2017. Further support will come from public investment projects, including road upgrades and new investment arising from the South Australian Government's Energy Plan. These positive developments are expected to mitigate the impacts of the cessation of automotive manufacturing.
- Tasmania's economic (2.5%) and employment (1.4%) growth over 2017-18 is expected to be significantly stronger than in recent years. The tourism and agricultural sectors are growing strongly, with forest industries and mining showing some recovery. Business confidence is increasing and the construction sector and housing market are strong. Public wage rises are to be kept within 2% a year and population growth is at its long term trend rate of 0.6%.
- The ACT economy is expected to grow at 2.75% in 2017-18. The growth is expected to be broad based, with continued expansion of dwelling construction and service exports such as education, business services and tourism. Employment is expected to grow 1.5% annually in 2017-18 and the future. Population is expected to grow by 1.5% annually from 2016-17 onwards.
- The Northern Territory is expecting economic growth to moderate (1.0% in 2016-17 and 2017-18), with private investment to return to historical levels and State final demand to contract in 2017-18 (-2.8%) and 2018-19 (-5.0%). Population is expected to decline (-0.3%) in 2017 and employment growth will be subdued while unemployment increases.

Net operating balances and net debt

4 While New South Wales, Victoria, Queensland, South Australia and Tasmania are predicting budget surpluses in 2017-18 and over the forward estimates, Western Australia, the ACT and the Northern Territory are predicting deficits over the period. Net debt is expected to fall in New South Wales and South Australia, remain stable in Victoria and Tasmania, and increase in Queensland, Western Australia, the ACT and the Northern Territory.

- New South Wales is forecasting a budget surplus of $2.7 billion in 2017-18, declining to $1.5 billion by 2020-21. Over the budget and forward estimates

(2017-18 to 2020-21), revenue is forecast to decline as a proportion of GSP as property transfer duty inflows return to trend, GST growth falls to record lows and National Partnership Payments decline. Expenses as a proportion of GSP are expected to fall over the forward estimates years as New South Wales intends to maintain control on expenses to match falling revenues. It is estimating a net debt of -$7.8 billion at 30 June 2017, the lowest since comparable records began in 1996-97. However, net debt is expected to increase to $18.6 billion in 2020-21 or 2.7% of GSP. This is due to increased capital expenditure.

- Victoria is predicting average budget surpluses of $2.4 billion over the forward estimates, expecting revenue growth of 3.7% and expenses growth of 3.2%. Net debt is expected to stay at 6% of GSP, about $24 billion in 2017-18.
- In 2016-17, Queensland expects a $2.8 billion surplus due to a short term spike in coal prices, and the timing of the cyclone Debbie payments from the Commonwealth. With falling nominal revenues and growing expenses, this will fall to $146 million in 2017-18, and fall marginally further in 2018-19. General government debt is forecast to rise from 60% of revenue in 2017-18 to 70% in 2020-21.
- Western Australia is forecasting a deficit in 2017-18, reflecting a projected shortfall between revenue (of $28.5 billion) and recurrent spending (of $30.8 billion). General government revenue is expected to increase in 2017-18 and over the forward estimates. Western Australia's preferred metric for net debt, 'total public sector net debt', is forecast to increase from $32.5 billion at 30 June 2017 to $43.6 billion at 30 June 2018 due to a subdued outlook for revenue and increased spending on economic and social infrastructure.
- South Australia expects a budget surplus of $72 million in 2017-18. The surplus is expected to increase over the forward estimates to $462 million in 2020-21. Real growth in revenue is expected to slow marginally to 2.8% in 2017-18 (3.7% in 2016-17), while expense growth is expected to decline in real terms to 3.7% (from 4.1% in 2016-17). Net debt to revenue ratio is down substantially from 46.1% in 2013-14 to 31.7% in 2017-18.
- Tasmania expects its net operating balance to be in surplus over the budget and forward estimates period ($812 million in 2016-17 which includes the Mersey hospital funding of $730 million and other one-off capital payments); $54.3 million is predicted in 2017-18 and surpluses of about $50 million in following years. However, the underlying net operating balance is expected to be in deficit. A fiscal balance deficit is expected in 2017-18 improving to a surplus in 2020-21. Net debt will be negative over the budget and forward estimates period.
- The ACT forecasts a headline net operating deficit of $73.9 million in 2016-17 and a deficit of $83.4 million in 2017-18, then surplus from 2018-19 to 2020-21. It expects net debt to increase over the period.

- The Northern Territory expects significant budget deficits in 2017-18 and over the budget cycle due to reduced GST revenue, lower taxation revenue and a moderation of economic growth. Debt levels are forecast to increase due to the reduction in GST, increase in interest payments on borrowing, increased infrastructure investment and a requirement to maintain core government services.

MAIN SPENDING AND REVENUE INITIATIVES

5 Most States are placing a heavy emphasis on infrastructure spending – mainly for education, health and transport.

6 There are a range of revenue initiatives across the States. These relate to insurance duty, taxes on foreign or absentee owners of properties and vacant properties, point of consumption wagering tax (South Australia and Western Australia) and changes to stamp duty (or grants) for first home buyers (New South Wales, Victoria and the ACT). The other major initiative announced by South Australia is a major bank levy from 1 July 2017 on all deposit taking institutions that operate in the State and are liable for the Commonwealth Government major bank levy. Western Australia has introduced a new (temporary) progressive payroll tax scale for large employers with a new marginal rate of 6% for businesses with payrolls above $100 million, and 6.5% for businesses above $1.5 billion. The gold royalty rate will also increase.

STATE 2017-18 BUDGET FORWARD YEAR GST ESTIMATES

7 Table 1 below shows the estimated GST revenue to be received by each State over the period 2016-17 to 2020-21, as included in State 2017-18 budget papers. The majority of States apply their own modelling to derive these estimates, rather than use the projections included in the Commonwealth 2017-18 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

	2016-17	2017-18	2018-19	2019-20	2020-21
	$m	$m	$m	$m	$m
NSW	17 186	17 554	17 607	17 555	18 250
Vic	13 655	14 744	16 142	17 036	18 001
Qld	13 939	14 871	14 490	15 042	15 772
WA	1 944	2 229	3 030	3 967	4 652
SA	5934	6303	6554	6786	7171
Tas	2 299	2 387	2 467	2 509	2 578
ACT	1 126	1 225	1 287	1 325	1 399
NT	3 183	2 909	3 030	3 150	3 302
Total	59 266	62 222	64 607	67 370	71 124

Source: Australian Government 2017-18 *Budget paper no. 3*; State 2017-18 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.

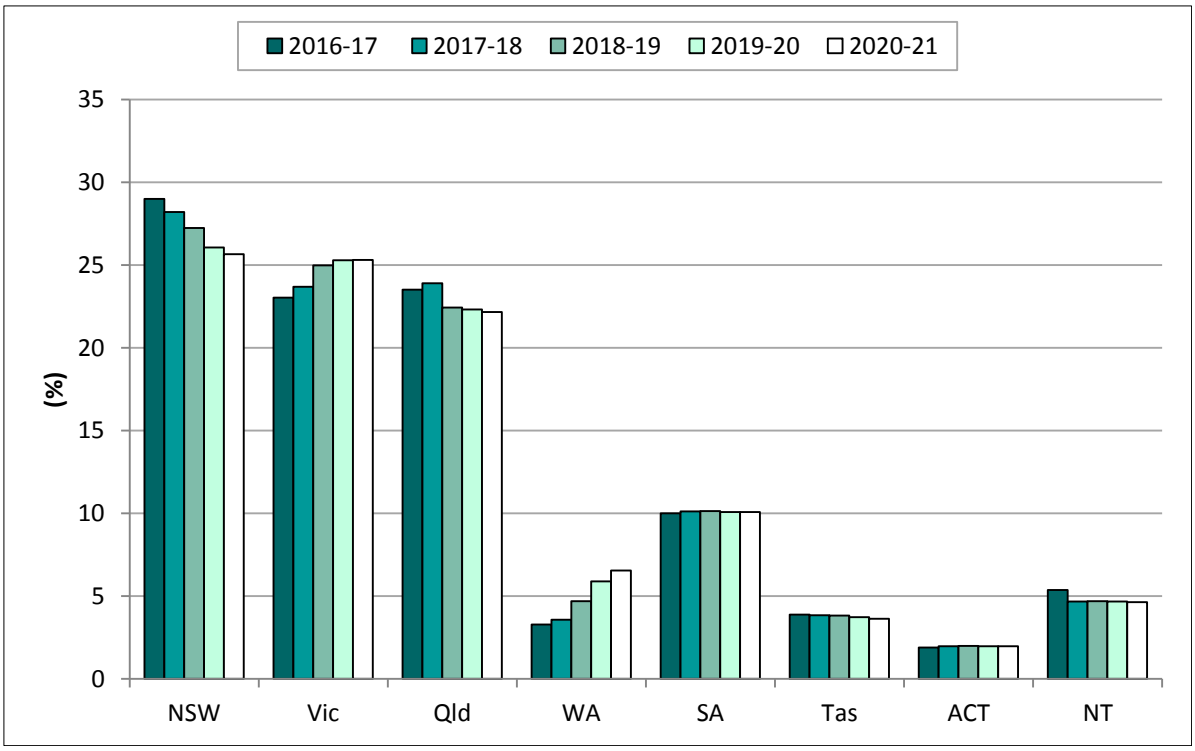
9 Changes in each States' estimated share of GST revenue are explained in their budget papers as follows:

- By 2020-21, New South Wales' GST relativity is expected to decline to a historic low of 0.79 – largely reflecting its strong economic performance.
- Victoria anticipates that its GST revenue will grow by 8.0% to $14.7 billion in 2017-18 and to increase on average by 6.9% a year over the forward estimates. This reflects an improvement in Victoria's share of the national GST pool, in part due to continued strong population growth relative to other States.
- In 2017-18, Queensland expects to receive $14.871 billion of GST revenue, $931.5 million or 6.7% higher than the amount received in 2016-17. This is due to an increase in its relativity. It expects its GST share to fall over the forward estimates but doesn't explain why.
- Western Australia's GST grants are forecast to rise from $2.2 billion in 2017-18 to $4.7 billion in 2020-21, reflecting the lagged response of GST relativities to the fall in iron ore royalties in 2014-15, as well as a reduction in North West Shelf grants and weak growth in taxes after 2013-14. Western Australia is predicting an increase in its relativity from 0.344 in 2017-18 to 0.617 in 2020-21.
- South Australia's GST share is expected to remain relatively constant over the forward estimates period. The amounts primarily reflect the Commonwealth's 2017–18 Budget downward revision of national GST pool estimates from 2016–17 to 2019–20, South Australia's relative population growth being slower than forecast and with a more than offsetting increase in South Australia's

relativity in 2019-20. The latter is due to a decline in South Australia's relative revenue raising capacity and a lower projected share of Specific Purpose and National Partnership payments.

- GST payments to Tasmania are expected to be $2 387.4 million in 2017-18. The growth in GST revenue over the forward estimates reflects GST pool growth, offset by a gradual reduction in Tasmania's GST relativity and lower than average population growth. After rising during the mining boom, Tasmania's GST relativity is forecast to return towards the long-term trend over the forward estimates as a result of comparatively weaker own-source revenue growth forecast in Western Australia and other resource-rich States; slow population growth in Tasmania compared to the national average, which reduces the CGC's assessment of Tasmania's need to invest in infrastructure; and a slightly higher share of Commonwealth payments.
- The ACT expects its GST share to remain constant over the forward estimates. It expects actual revenues to increase due to changes in the GST pool and population, but it has held its relativity constant.
- In 2017-18, the Northern Territory is expected to receive $2 909 million in GST, a decrease from the previous year. The decrease is caused by a reduction in the Territory's GST relativity and a reduction in the Northern Territory's share of the national population. GST revenue is projected to remain below 2016-17 levels over the three year period to 2019-20.

Figure 1 State estimated GST revenue shares, 2016-17 to 2020-21



Source: State 2017-18 budget papers.

STATE COMMENTS ON FEDERAL FINANCIAL RELATIONS

New South Wales

10 New South Wales welcomes the Productivity Commission's *Inquiry into Horizontal Fiscal Equalisation* (the PC Inquiry), and supports reform that moves towards a per capita distribution of GST. It says the current system for allocating GST penalises New South Wales for having the nation's strongest performing economy. It says its share of per capita GST will fall, giving the State its lowest share of GST on record and leading to New South Wales' GST revenues declining in real terms.

Victoria

11 Victoria makes no mention of the PC Inquiry but notes that there are three risks to its GST – its population growth, slow growth in GST revenue and changes in prices and volumes of iron ore in Western Australia.

Queensland

12 In her budget speech, the Premier focused fairly heavily on the Commonwealth not providing sufficient support to Queensland. In addition, Queensland noted the following.

- The original intent of the Intergovernmental Agreement on Federal Financial Relations was to limit the number of National Partnerships (NPs), allowing for funding to flow to states for efficient service delivery and reduce the reporting burden. Over time, the number of time-limited and low-value NPs has increased, reducing budget certainty and raising community expectations for ongoing services. When agreements expire, States are left with limited opportunities to deal with the expiring NP as the final decision on continued funding is made through the Australian Government's budget process.
- Queensland is concerned with the 'conditions imposed on access to funding such as for the Skilling Australians Fund and the new National Housing and Homelessness Agreement. Such conditions are inconsistent with the principles of the Intergovernmental Agreement on Federal Financial Relations.'
- The Queensland Government intends to provide a submission to the PC Inquiry in support of the principle that all States should have the fiscal capacity to provide similar levels of services and infrastructure. It is also essential that the different circumstances and challenges each State faces are recognised to ensure similar levels of services can be delivered regardless of where someone lives.

Western Australia

13 Western Australia notes the CGC uses a three-year average of the latest available historical data on States' fiscal capacities (GST grants in 2017-18 are based on data from 2013-14 to 2015-16) and that if all time lags were removed from the CGC process, Western Australia's GST grants would be $7.7 billion higher across the five years from 2016-17 to 2020-21.

14 It also notes that the GST subsidy from Western Australia to the other States is just one part of the State's overall annual net contribution to the Australian Federation, which now stands at $21.7 billion for 2015-16, according to the Western Australian Department of Treasury's latest estimates.

15 In relation to the PC Inquiry, Western Australia notes it provided a submission which outlines 'its findings that the current system fails to achieve its equity objective, while imposing significant budget costs and undermining economic growth.' Furthermore, Western Australia:

> […] identified a package of reform options that would promote efficiency and economic growth across Australia with all States benefitting from the proposed reforms in the long run. These include:
>
> - moving to an equal per capita distribution in the long run, with the Commonwealth providing assistance for weaker States;
> - a GST relativity floor;
> - using a global revenue base to assess States' revenue raising capacity (instead of separate assessments for royalties, land tax, stamp duty, payroll tax etc);
> - discounting revenue assessments (allowing States to keep a reasonable share of the revenue generated locally);
> - better accounting for the costs of developing economies; and
> - distributing GST on the basis of contemporaneous assessments of revenues and costs (i.e. removing the time lags in the system).[1]

South Australia

16 The budget contains a description of how the GST shares are derived, and the main factors influencing South Australia's higher relativity in the 2017 Update compared with that in the 2016 Update.

17 Under 'Developments in Commonwealth-State relations', the Budget describes the PC Inquiry. South Australia strongly supports the continuation of the current HFE arrangements. It says HFE is not detrimental to national productivity, does not restrict

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[1] From Western Australia's Budget Paper No 3, 2017-18.

the appropriate movement of population and capital and does not act as a disincentive to economic activity, including in the natural resources sector.

18 It is also noted that the CGC has received terms of reference for a 2020 Review. It says it is possible that the findings of the PC Inquiry could influence the 2020 Review.

19 The Risk statement (Chapter 6) refers to the revenue risk of changes to HFE methodology and data. It says changes recommended by the PC Inquiry could, if implemented, result in negative or positive impacts on GST revenue grants to South Australia. It says a 0.01 change in South Australia's relativity (from the 2017 Update relativity of 1.43997) would result in a change in GST revenue grants of about $44 million.

20 As in previous budgets, South Australia has replicated the Commission's ratios of actual to assessed tax revenue (formerly known as the assessed revenue raising effort ratios) to demonstrate that it is a relatively low taxing State.

Tasmania

21 Tasmania noted that GST Revenue is the largest single source of revenue for Tasmania, representing 40.6% of Total General Government Sector revenue in 2017-18. It also noted the announcement of the PC Inquiry, and said that the inquiry put at risk the distribution of the GST in accordance with the principle of HFE.

22 It goes on to say:

> In 2017-18, the GST distribution will deliver $1.1 billion more revenue to Tasmania than its population share. The Commonwealth Grants Commission, in recommending Tasmania's GST share, recognises the above average cost of providing services to Tasmania's smaller, more regional and more disadvantaged population, and Tasmania's limited own-source revenue base. This additional $1.1 billion in GST revenue represents approximately 18% of Tasmania's total revenue in 2017-18 and the [PC Inquiry] presents a significant risk to Tasmania's Budget over the forward estimates period and beyond.[2]

ACT

23 The ACT recorded the following views:

- the current approach to HFE achieves the goals of the equalisation system
- the concerns identified in the terms of reference for the PC Inquiry have, in most cases, been thoroughly addressed in previous reviews, including the 2011-12 Brumby/Greiner review, which validated the effectiveness and fairness of the current approach to HFE.

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[2] From Tasmania's Budget Paper No 2, 2017-18.

Northern Territory

24 In its 2017-18 budget documents, the Northern Territory sets out the HFE process in a factual manner and notes the outcome of the 2017 Update. It again reports revenue effort ratios by jurisdiction.

CONCLUSIONS

25 While the Northern Territory economy is facing tough times, the other States are expecting their economies to strengthen. New South Wales, Victoria, Queensland, South Australia and Tasmania are predicting budget surpluses in 2017-18 and over the forward estimates. The others are predicting deficits.

26 Net debt is expected to fall in New South Wales and South Australia, remain stable in Victoria and Tasmania and increase in Queensland, Western Australia, the ACT and the Northern Territory.

27 Most States are placing a heavy emphasis on infrastructure spending – mainly for education, health and transport. Most revenue changes appear minor although the South Australia's bank tax and Western Australia's changes to payroll tax and gold royalty rate are more substantial.

28 Again, most States have a reasonable understanding of how the changes in their fiscal circumstances will influence their GST shares.

29 Their positions in relation to the HFE system and the PC Inquiry (supporters or detractors) are predictable.