The Queensland Commission of Audit Interim Report - June 2012: A Critical Review

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Executive Summary

* The report of the Audit Commission has been presented as an independent assessment of the state’s finances. In reality, the appointment of an Audit Commission is a routine political manoeuvre undertaken by incoming governments seeking to abandon electoral commitments.

* The Commission has not discovered any ‘black holes’ or substantial mis-statements in the budget estimates of the outgoing Labor government. These estimates have been confirmed, with modest changes, in the May 2012 forward estimates prepared by Treasury for the LNP government.

* The Commission’s claims that projections of revenue and expenditure (made under the previous government and reaffirmed in the May 2012 forward estimates) are over-optimistic does not stand up to scrutiny in most respects. The Commission’s extrapolation of recent experience implicitly assumes a repetition of the financial crisis and natural disasters that generated recent large deficits.

* The Commission’s focus on gross public sector debt is misplaced. The most relevant measure of the balance sheet as a whole, public sector net worth, remains strong. Focusing purely on financial assets, Queensland’s net financial debt remains comparable to, or slightly below, the average level of other states when expressed as a proportion of government revenue.

* Like all state governments, Queensland faces the problem of meeting growing demands for services such as health and education, while having access to only a limited range of revenue sources. State governments have further exacerbated the problem by offering distorting concessions and exemptions that have eroded the efficiency and revenue effectiveness of the taxes that are available to them, most notably land tax and payroll tax. Queensland has gone further than any other state in this respect, and its finances have therefore proved particularly vulnerable to shocks such as the global financial crisis and the natural disasters of 2011.

* Simply by matching the thresholds and rates applicable to land and payroll tax applicable in NSW, Queensland could raise up to $1 billion a year in additional revenue. The shortfall in tax revenue caused by these unjustified concessions is the primary reason for Queensland’s budget difficulties. The Commission recognises the distortions and inefficiency associated with these concessions but proposes no concrete measures to address them.
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Introduction

One of the less edifying traditions of Australian politics is that of newly-elected (or re-elected) governments discovering a ‘black hole’ in the public finances, meaning that electoral promises have to be abandoned, or that large-scale cuts, not mentioned during the election campaign, have to be imposed.

The practice of abandoning electoral commitments on the basis of alleged discoveries of unannounced budgetary problems dates back to 1978, when newly appointed Treasurer John Howard withdrew the ‘fistful of dollars’ tax cut promise, on which the Fraser government had been re-elected the previous year. Despite a vitriolic public response, Howard's repudiation of election promises set a precedent for the future.

The abandonment of election promises following the real or supposed discovery of unsuspected budgetary problems become been a bipartisan practice in recent decades. Following the election of the Hawke Labor government in 1983, Treasury Secretary John Stone (later a National Party Senator) advised the government that the budget position was worse than announced and required the abandonment of election promises, advice the government followed.

Labor governments have continued with this ad hoc approach to the post-election discovery of budget blowouts, requiring large scale breach of promises. The most recent example was the Bligh government in Queensland, which discovered, immediately after the 2009 election that it needed to sell off a wide range of public assets. The voters were unimpressed, and their anger did not abate over time, handing Labor the most crushing defeat in the party’s history.

By contrast, the conservative parties have formalised and ritualised the process. The key innovation was the idea of a Commission of Audit, introduced by John Howard and Peter Costello after the 1996 election. Since Howard had promised, before the election, to stick to his commitments regardless of the state of the budget, the unsurprising post-election discovery of a ‘Black Hole’ was not enough to set him free.

The impressive machinery of the Commission of Audit, and its predictably alarming report, laid the ground for the invention of the then-new category of ‘core promises’ which were to be kept, with the rest becoming ‘non-core’. Since 1996, the establishment of a Commission of Audit has been a routine step for newly elected conservative governments, as has the release of alarming findings of financial mismanagement by the outgoing Labor government.

The Liberal National Party government, led by Campbell Newman, has been more enthusiastic than most in this respect. In selecting Peter Costello himself to chair its
Commission of Audit, it guaranteed that this now ritual event would have a high profile. Despite revealing little that was not already on the public record, the Commission’s Interim report has been used to justify massive cuts in the public sector, with the projected loss of 20,000 jobs.

The role and function of Commissions of Audit

The establishment of a Commission of Audit has been a routine measure for newly elected conservative governments since the election of the Kennett government in Victoria in 1992. Most notably, Peter Costello, Treasurer in the incoming Howard government, appointed a commission headed by Professor Robert Officer, a leading free-market economist.

The primary stated task of these Commissions, as implied by the name, is to review the current and forecast condition of public finances and to make recommendations for improvement. In reality, however, the primary function has been to justify cuts in public expenditure and other policy changes. In most cases, these policy changes have not formed part of the platform on which the newly elected government campaigned and, in many cases, they represent a direct repudiation of election promises.

In this context, it is useful to present a brief review of the circumstances in which the 1996 Commission operated. In the leadup to the 1996 election, it was generally expected that the deficit for the forthcoming fiscal year would be substantially larger than had been estimated in the Budget papers. As a result, then Opposition Leader John Howard was pressed on whether he would repeat the common practice of abandoning election commitments if the budget position was indeed worse than estimated. Howard stated that the promises were unconditional (Dullard and Hayward 1998),

In this context, the Howard government required some exceptional steps to justify breaking its commitments anyway. These included the characterisation of the (widely known) Budget deficit as a ‘Black Hole’, the invention of a category of ‘core’ promises (the implication that other promises were ‘non-core’ was the subject of some derision) and, most importantly, in the present context, the appointment of the Commission of Audit. The Commission’s report gave the government the intellectual ammunition it needed to justify an austerity program (Barbara and Gahan 2000).

The same process has been undertaken by newly elected conservative governments in Western Australia, New South Wales and Victoria. In every case, the result has been support for cuts in public expenditure, typically involving the repudiation of election commitments.

To sum up, despite the neutral-sounding name, a Commission of Audit is not an independent assessment of public finances and the accuracy of public accounts. Rather, it is an ideological
exercise with a predetermined outcome. As will be shown in this study, this is particularly true of the Costello Commission of Audit.

**Is there anything new?**

In political terms, the central claim made by Audit Commission reports is that the budget position is substantially worse than was claimed by the outgoing government, thus necessitating the repudiation of election promises made by the new government. The Costello Commission makes this claim in its executive summary saying (p10)

> The magnitude of the fiscal repair task is substantially larger than previously recognised, as the former Government has locked in expenditure commitments and taken unrealistically optimistic budget assumptions to mask the magnitude of the underlying structural problems.

The Commission claims both that revenue projections in the forward estimates are unrealistically high and that expenditure projections are unreasonably low. This claim is based on an extrapolation of the trends of the last five years, shown in Chart 1.2.

Consider first the Commission’s claims regarding revenue. The main criticisms refer to projections regarding property transfer duty and royalty revenue. As the Commission notes, revenue from both of these sources rose to unsustainably high levels in the years before the global financial crisis, before falling sharply in the case of property transfer duty and more modestly in the case of royalty income (Chart 3.11)

The Commission’s extrapolation therefore relies on an implicit assumption that the next five years will see a similar deterioration in revenue from these sources. That is, in effect, the extrapolations assume a repetition of the global financial crisis. By contrast, as shown in Chart 3.11 the budget estimates project a gradual recovery to pre-crisis levels by 2015-16.

It is crucial to note at this point that the revenue estimates have been reaffirmed in the May 2012 MYFER produced by Treasury after the change of government. Thus, whereas the Commission suggests a problem of over-optimism on the part of the previous government, it is actually claiming that the official revenue projections of the current government are unrealistically high.

The Commission effectively admits this, stating that it proposes applying a ‘conservative bias’ to revenue estimates for royalty income and proposing the use of a pessimistic growth scenario for projections of transfer income. That is, as regards revenue, its claim is not that the previous government’s projections, reaffirmed in the MYFER were ‘unrealistically optimistic’ but that it is appropriate to use pessimistic assumptions rather than making the best possible estimate of future revenue.
As regards expenditure, the Commission focuses on two main items where it regards the Budget projections as unrealistically optimistic: capital expenditure and employee expenses. As regards capital expenditure, the Commission notes that general government capital expenditure, as a share of GSP rose rapidly from 2003-04 onwards (Chart 8.6). This reflected a number of factors including once-off expenditures in response to the natural disasters of 2011, an expansion of capital spending in response to the global financial crisis, and catch-up expenditure necessitated by population growth, which was particularly rapid during this period. The forward estimates call for levels of capital expenditure, relative to GSP, to fall back to the historical level (Chart 1.9), reflecting the fact that all of these special factors will cease to apply over the period of the forward estimates.

The Commission gives no credible reasons for supposing that these estimates are unreasonable. More importantly, it is once again in the position of criticising not the estimates of the previous government, but those of the current government. The MYFER projections incorporate the capital expenditure commitments made by the LNP in its election platform. Thus, the Commission’s claim here is that the current government will choose to implement previously unannounced capital expenditure programs.

The Commission’s final claim relates to employee expenses. This is obviously crucial since the Budget problems allegedly discovered by the Commission have been used to justify massive cuts in employment, directly repudiating the LNP election promise that ‘public servants have nothing to fear’.

Growth in employee expenses may be partitioned into two components: growth in average wages and salaries and growth in employee numbers. Although the Commission frequently aggregates the two, to produce alarmingly large numbers, it is more useful to consider them separately.

As regards wages, the forward estimates call for annual wage increases of 2.5 per cent (that is, roughly constant real wages) in line with the stated policy of the Labor government. The Commission correctly notes that, at least under current industrial law, the government does not have the power to ensure that the AIRC restricts wage increases to a level consistent with government policy and that actual increases in wages have averaged 3.25 per cent. The implications of this discrepancy will be discussed below. However, as regards the general claim that the government has been unrealistically optimistic, the Commission concedes that it is standard practice to base forward estimates on existing government policy.

Since total employee expenses for Queensland are around $20 billion a year, assuming annual wage increases of 3.25 per cent rather than 2.5 per cent increases outlays by $150 million in 2012-13 and by a total of around $1.5 billion over the period over the forward estimates. In the context of total revenue and expenses of more than $200 billion over the same period, this is a relatively modest adjustment. Modest changes in other tax and expenditure policies, discussed below, could more than offset this change.

As regards employee numbers, the Commission notes that the Labor government substantially expanded public service employment, with a primary focus on increasing the number of frontline employees (the Commission expresses the view that this expenditure was
not justified by results, a point that will be addressed further below). However, the forward estimates of the previous government call for annual growth of only 1.5 per cent.

The Commission describes this as unreasonably optimistic, but this claim makes no sense. All that is required to ensure that the commitment is delivered is that the new LNP government should adhere to the stated policies of the outgoing government. In reality of course, the government has already announced massive cuts in employment, and proposes to cut up to 20,000 positions or 10 per cent of the total. Even assuming that the initial cuts are scaled back and that most of the lost positions are ultimately replaced, it is clear that these cuts greatly exceed what is required to meet the budget projections of the previous government.

Thus, the Commission’s claim that the previous government’s budget projections were based on unreasonably optimistic assumptions does not stand up to scrutiny. The forward estimates made by Treasury under the previous government have been reconfirmed, with marginal changes, under the current government. The Commission wisely avoids relying on the unjustified extrapolations presented in its executive summary, and instead uses the Treasury estimates.

The alarming numbers presented by the Commission regarding public debt do not arise from the discovery of previously unsuspected problems in the public accounts. Rather they arise from the Commission’s decision to focus on the largest debt number to be found in the accounts (gross debt for the entire public sector) rather than measures of general government net debt or net worth.

The merits of the Commission’s choice of debt measure will be discussed further below. As regards the political justification for the LNP government’s repudiation of its promises, what matters is that the level of gross debt, and its likely future growth, were well known before the election. In fact, criticism of high levels of debt formed a significant part of the LNP’s election campaign. Promises to preserve job security for public servants were made in full knowledge of the level of public debt, and nothing in the Audit Commission report changes that.

**Gross debt, net worth and net financial debt**

The primary emphasis of the Commission’s Interim report is on allegedly unsustainable levels of state debt.

Unsurprisingly, given its political objective, the Commission chooses to focus on the largest possible measure of debt, namely the gross debt of the entire public sector. The choice of a gross measure means that no account is taken of the value of financial and physical assets held by the public sector. If the same approach were taken in evaluating the financial position of a household, it would entail worrying about an outstanding credit card balance, without considering whether the household had money in the bank to make the required payment. Similarly, it would imply that a family with a house valued at $500,000 and a mortgage of $200,000 was worse off than one living in rental housing, with no assets and no debts.
The inclusion of the debt of government business enterprises is even harder to justify. These enterprises are required to cover debt from their own earnings and to generate a commercial rate of return on the equity invested in them. The Commission’s analysis is akin to suggesting that a household would be worse off owning a profitable business, because the business is partly financed by debt.

The most comprehensive measure of the financial position of the Queensland government is the net worth of the public sector, that is, the total value of publicly owned assets, less liabilities, including public debt. A focus on net worth produces an analysis radically different from that presented in the Commission’s report, let alone the apocalyptic scenarios presented by Premier Newman.

As shown in Chart 2.11, the net worth of the Queensland public sector rose dramatically between 2000-01 and 2008-09, from around $60 billion to $185 billion. The financial crisis and natural disasters resulted in a small decline, to $170 billion, in 2010-11, but the forward estimates project a steady recovery.

The growth in public sector net worth since 2000-01 reflects the high levels of investment that have prevailed over this period. In economic terms, this investment will yield a stream of benefits over coming years, including improvements in health, education and transport services.

Although net worth is the most relevant single measure of the government’s assets and liabilities, it is not the most important measure as regards fiscal policy, since non-financial assets typically yield a flow of services rather than a flow of income. To determine the implications of debt and assets for government expenditure, it is useful to confine attention to financial assets and liabilities, since these determine the financial obligations of government. The relevant measure here is net financial debt, the difference between financial assets and liabilities (referred to by the Commission simply as ‘debt’). As shown by the Commission (Chart 2.4, p21) while Queensland’s net financial debt has risen as a result of the economic crisis and natural disasters, it remains comparable to, or slightly below, the average level of other states when expressed as a proportion of government revenue. In view of Queensland’s low tax effort, the comparison would be even more favourable, if undertaken on the basis of the ratio of net financial debt to state product.

To sum up, the gross debt measure favoured by the Commission is economically nonsensical. On the relevant measures of a state’s financial position, namely net worth and net financial debt, Queensland remains in a strong position, both absolutely and compared to other states.

AAA ratings

The Commission lays great stress on the desirability of a AAA rating, and implies support for drastic cuts in public expenditure in order to regain a rating. There are two reasons why a AAA rating might be considered desirable.
The first is that the ratings agencies might be regarded as giving an independent and accurate assessment of the state’s financial performance. In reality, the performance of ratings agencies over the past decade has been spectacularly poor. Most notably, in the leadup to the 2008 financial crisis, thousands of financial derivatives, which were based on low-quality mortgages and which ultimately proved worthless, were given AAA ratings. More importantly, ratings agencies represent only the interests of bondholders, and therefore prioritise low debt levels at the expense of all other considerations.

The second reason for desiring a AAA rating is that it reduces borrowing costs. As the Commission points out, the absence of a AAA rating increases Queensland’s borrowing costs by around 0.4 percentage points, with a resulting increase in debt servicing costs of $100 million a year. Other things being equal, lower borrowing costs are desirable. However, if the pursuit of a AAA rating results in forgoing socially beneficial investments, the costs may well exceed savings in debt servicing costs.

In the private sector, most corporations have decided that the costs of forgoing investments to secure a AAA rating outweigh the benefits.


‘in corporate America, the AAA rating long ago became an anachronism … In the early 1980s, around 60 companies had AAA credit. By 2000, the number of AAA companies was about 15. Today just four corporations [are rated AAA].’

This decision reflects the fact that well-run corporations are focused on maximising their net worth. Maximising net worth is not, however, the best route to get an AAA credit-rating. Ratings agencies represent the interest of bondholders, and for them more debt is almost always bad, even if it is used to finance productive investments, whether by corporations or governments.

The commission displays an uncritical acceptance of the view that Queensland should be run in the interests of bondholders, as evaluated by ratings agencies. Its report contains no discussion at all of whether the cuts it proposes will enhance the economic and social welfare of Queenslanders: the desirability of pleasing bondholders and ratings agencies is taken as self-evident.

**Income and expenditure**

Although the picture of Queensland’s finances presented by the Interim Report is highly misleading, the Commission correctly characterises a long-standing problem with the Queensland state budget. As shown in Chart 1.8 p7, the level of services spending is about equal to the average level for other states, but revenue-raising effort has been consistently below the national average.
This contrasts with the situation prevailing for much of the 20th century, when Queensland had both low expenditure and low taxes. As an illustrative example, until the early 2000s, Queensland children received one year less of schooling than those in other states (the result of an economy measure introduced as a response to the baby boom in the 1950s). Lower provisions of education services was reflected in poor outcomes, such as a rate of university attendance well below the national average.

Strong economic growth and a booming housing market during the decade leading up to the global financial crisis allowed the government to expand services provision while still retaining relatively low taxation levels, justified on grounds of interstate ‘competitiveness’. However, this is not a feasible strategy in the long term.

The Commission states (p 188):

Queensland has become a high expenditure state, whilst remaining a low taxing state. This situation is unsustainable

This statement is inaccurate in that, although the relative position varies from year to year, Queensland does not, on average, spend more than other states. It would be more accurate to say that Queensland has become a normal expenditure state, whilst remaining a low taxing state. There is, however, no doubt that such a situation is unsustainable in the absence of windfall flows of revenue.

The Commission’s observations in this respect are scarcely novel. The dangers of a low-tax strategy have been pointed out by the Queensland union movement for at least a decade. For example the 2004 QCU Budget submission observed:

Queensland has made a gradual transition from an economic strategy based on low taxes, low service provision and exploitation of natural resources to a 'Smart State' strategy requiring high quality services in areas such as health and education, but the transition has been more complete in relation to expenditure than in relation to revenue.

...Queensland is only slightly below the Australian average in measures of actual expenditure per person and of expenditure effort.

A detailed analysis reveals differences reflecting the continuing impact of a low-tax, low-service strategy. In core services like health and education, expenditure and effort are now close to the national average. On the other hand, Queensland spent less on a range of ‘quality of life’ services and more on a range of concessions and assistance to business.

These observations are, broadly speaking, as valid today as they were in 2004. In particular, Queensland remains an outlier in terms of the range of special tax concessions for business and subsidies designed to attract business. Such policies might be appropriate in a state that
was facing a problem of declining population. Their persistence in a state that faces continuing difficulties with rapid growth is nonsensical.

Although the Commission’s data shows that the primary difference between Queensland and other states arises from Queensland’s low tax effort, its analysis and recommendations take no account of this fact.

**Queensland’s revenue shortfall**

An examination of the budget papers shows that the fiscal problems identified by the Commission arise primarily from low tax effort.

The most striking instance relates to payroll tax. Queensland has been the leader in this field. Queensland has a payroll tax threshold of $1.0 million, about twice the level prevailing in other states, and a rate of 4.75 which is the lowest of any state. At a time when an alleged financial crisis is being used to justify massive cuts in employment, the LNP government has announced that the threshold will be raised to $1.1 million at a cost of $40 million per year.

If the payroll tax were raised to the rate of 5.45 per cent prevailing in NSW, our most direct competitor, it would yield additional revenue of approximately $600 million per year. If, in addition, the threshold were lowered to to the NSW value of $690 000, instead of being increased, it would yield a further $200 m. Allowing for growth in line with GSP, this measure alone would be sufficient to restore the state to fiscal balance (the Commission’s stated goal) by 2014-15.

The use of concessional rates of payroll tax is the biggest single difference between Queensland and the other states, and results in a revenue shortfall of approximately $1 billion per year. The Commission’s only response to this massive shortfall is to state

The Commission does not make any recommendations in relation to the base or rate of payroll tax other than to suggest the Government closely monitor developments in other states with a view to maintaining both a competitive and robust revenue base.

In this context, ‘competitive’ may be taken as code for ‘low’ and ‘robust’ as code for ‘high’, leaving the Commission advocating both nothing and everything.

The Commission’s treatment of land tax is only slightly more satisfactory. As the Commission notes

Land tax is considered a relatively efficient tax base if applied broadly, as application of the tax usually has minimal effect on taxpayer behaviour and how land is used.

As with payroll tax, Queensland applies both a high threshold ($600 000) and a low rate of taxation (starting at 1 per cent), along with other concessional features which reduce both efficiency and revenue raised. If Queensland adopted the same thresholds and rates as other states, it could generate additional revenue of $250 million per year.
The concessional treatment of wealthy property owners is justified in terms of tax ‘competitiveness’, with the Commission asserting that “Queensland has historically maintained a competitive taxation environment compared to other states.” This is entirely wrong as it applies to land tax. Since land is immobile, there is nothing competitive about low rates of land tax.

The Commission’s states, correctly that:

‘Broadening the land tax base by removing or reducing exemptions and concessions would remove current distortions in the application of land tax and improve the efficiency of the tax system’

However, the Interim Report offers no specific suggestions to improve the efficiency of the tax base. It does, however propose a temporary deficit reduction levy applied to all ratepayers, which would raise approximately $200 million per annum for every $100 of levy. It is notable that the Commission appears to prefer a regressive lump-sum levy on all properties to the equally simple alternative of a levy based on rateable value, which would require a larger payment from those most able to afford it.

A more satisfactory analysis would begin with the observation that the shortfall in Queensland’s tax effort is approximately $2 billion per year (10 per cent of own-source revenue of $20 billion per year. Eliminating this shortfall would ensure a substantial operating surplus, consistent with gradually declining ratios of public debt to revenue and GSP.

To sum up, the long-term gap between revenue and expenditure in the Queensland budget arises almost entirely from tax concessions that are distorting, inefficient and regressive. Other states offer substantially smaller, and less distorting, concessions. If Queensland offered the same concessions as other states, budget surplus would be restored once the impact of natural disasters was past.

**Capital expenditure and its financing**

As shown in the Commission report, Queensland has consistently higher levels of capital expenditure than other states. This is primarily due to more rapid population growth. Population growth implies a need for additional capital expenditure so that the stock of infrastructure per person (schools, hospitals, roads and so on) can be maintained at an adequate level. On the other hand, population growth implies that the revenues of the state government (own-source, GST and grants) can be expected to grow more rapidly than in states with slower population growth.

In these circumstances, it makes sense for the state government to maintain higher ratios of debt to current revenue than would be appropriate if the expected rate of revenue were growing more slowly.

**Concluding comments**
Like all state governments, Queensland faces the problem of meeting growing demands for services such as health and education, while having access to only a limited range of revenue sources. State governments have further exacerbated the problem by offering distorting concessions and exemptions that have eroded the efficiency and revenue effectiveness of the taxes that are available to them, most notably land tax and payroll tax. Queensland has gone further than any other state in this respect, and its finances have therefore proved particularly vulnerable to shocks such as the global financial crisis and the natural disasters of 2011.

The Audit Commission confirms this analysis, but chooses to focus instead on misleading and inappropriate measures of gross public sector debt, thereby providing a basis for the LNP government to repudiate its electoral commitments and introduce drastic and poorly thought-out cuts to employment and services. In reality, the state’s overall balance sheet, summed up by public sector net worth remains strong, and has improved over the last decade.

References

