

PROJECT.SOUTH AUSTRALIA

REVIEW • REFORM • REVITALISE

THE CASE FOR ECONOMIC AND FISCAL REFORM



NOVEMBER 2012

IPA Institute of
Public Affairs
Free people, free society

Introduction

'This new colony ... perfectly unshackled by prison discipline, by military governors, and by immense civil establishments, and wholly independent and free, threatens to annihilate the other colonies. If it be successfully establish, the colony of New South Wales will probably become an inferior, subordinate and subservient appendage to it.' (Sydney Herald, 26 October 1835)

Founded on the principles of civil liberty and religious tolerance, with wide and open spaces suitable for agricultural developments and population growth, and blessed with the avoidance of tensions associated with the early colonial authoritarianisms of New South Wales and Van Diemen's Land (Tasmania), the early residents and officials of the new colony of South Australia held high hopes for the future.

Grasping the mettle of opportunities provided by her natural resources and human talents, South Australians had quickly achieved among the highest living standards in the world within two generations of the state's short existence.

By the 1870s, a period in which Australia became the richest country on Earth, South Australia had a level of real GDP per capita exceeding that of her precocious neighbour Victoria. It is also instructive to recall that South Australia's wealth per person exceeded that of fledgling Western Australia throughout much of the late nineteenth and early twentieth centuries.

The virtuous melting pot of robust economic activity and population growth, including migration from interstate and overseas, brought social and cultural benefits to new and existing residents alike during that era, the legacy of which remains felt by South Australians today.

A spirit of political reform was also keenly felt in South Australia during its first hundred years, paving the way for transformative institutional changes. Most notable of these was the status of the colony as the birthplace of the Australian universal adult franchise, in which women were granted the right not only to vote but to stand as parliamentary candidates. Indigenous persons were also granted voting rights in the late 1800s.

Even today, potential sources of competitive advantage are opening up for South Australia. The vast deposits of minerals located within the state provide every potential of positioning South Australia as a global minerals province of international repute during the twenty-first century.

Potentially following the outstanding success of its local viticulture industry, the prospects for the substantial growth and development of other aspects of South Australian agribusiness appears to hold great economic promise into the foreseeable future.

With quality of life issues emerging as important considerations for individuals and families, recent lifestyle surveys indicate that Adelaide represents one of the most liveable cities in the world. This potential advantage is overlaid by the relative proximity of South Australia to an East Asian region whose inhabitants aspire to develop their economies to modern Western standards.

Due to a complex array of economic, political and social factors, South Australia has yet to capitalise on its seemingly unlimited potential. In fact, the available evidence suggests that relative contribution of South Australia to Australian economic and social life has been in relative decline during the twentieth and twenty-first centuries.

Ultimately it is South Australians themselves who have suffered from the loss of ambition and hope as the state drifts into irrelevance.

The unemployment rate has remained stubbornly above the national average, contributing to the largest proportion of welfare dependents to state population on the Australian mainland. Net interstate migration from South Australia, particularly in the 25 to 29 year age cohort, remains a serious concern for a state desperate to retain its best and brightest.

And recent events, most notably BHP Billiton's shelving of its \$30 Olympic Dam copper-gold-uranium mine expansion plan, seems to have compounded a sense of pessimism about the future prospects of the Festival State.

The state government has indicated that it intends to release a statement to help provide economic direction and thus revive South Australia's fortunes.

The sentiments expressed by the government may be admirable, but unlocking the potential of the state will require nothing less than a reversal of the high-taxing, high-spending and pro-regulatory policies pursued over the past decade.

In other words, to become the best place to live, work and invest in the world, South Australia must pursue economic reform approaches which inspire private sector entrepreneurship, attract labour and capital from interstate and abroad and, above all, reduce the influence of public sector activities in the state's economic affairs.

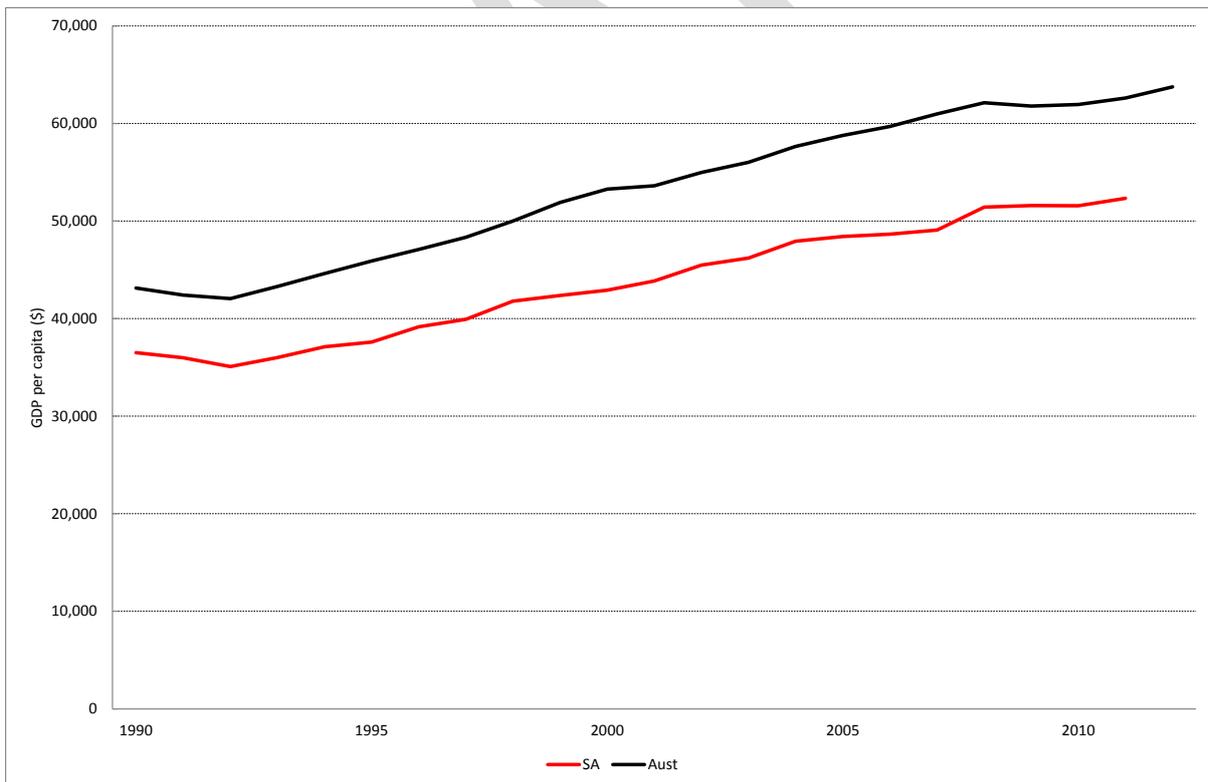
South Australia's economic growth has lagged behind, and its national and global economic significance has receded

A conventional measure of material living standards attained by a community is provided by real gross domestic product per capita, or the sum of gross value added divided by the number of people within the population. Provided the basis for calculating real GDP per capita is consistently made, changes in real GDP per capita can be compared across locations and over time.

South Australia has maintained a shortfall in real output per capita, compared with Australia as a whole, over the last two decades. In 2011 the state's real GDP per capita was about \$52,300 whereas the figure for Australia was about \$62,600. Notably, Australia as a whole attained a real output per capita level in 2000 similar to that attained by South Australia in 2011.

While the gap between South Australian real GDP per capita and Australian real GDP per capita has narrowed slightly in recent years, the long term trend has been for the disparity between state and national real output per capita to increase. In other words, South Australia has been falling behind in the 'fast lane' of national economic growth.

South Australia's real GDP per capita shortfall



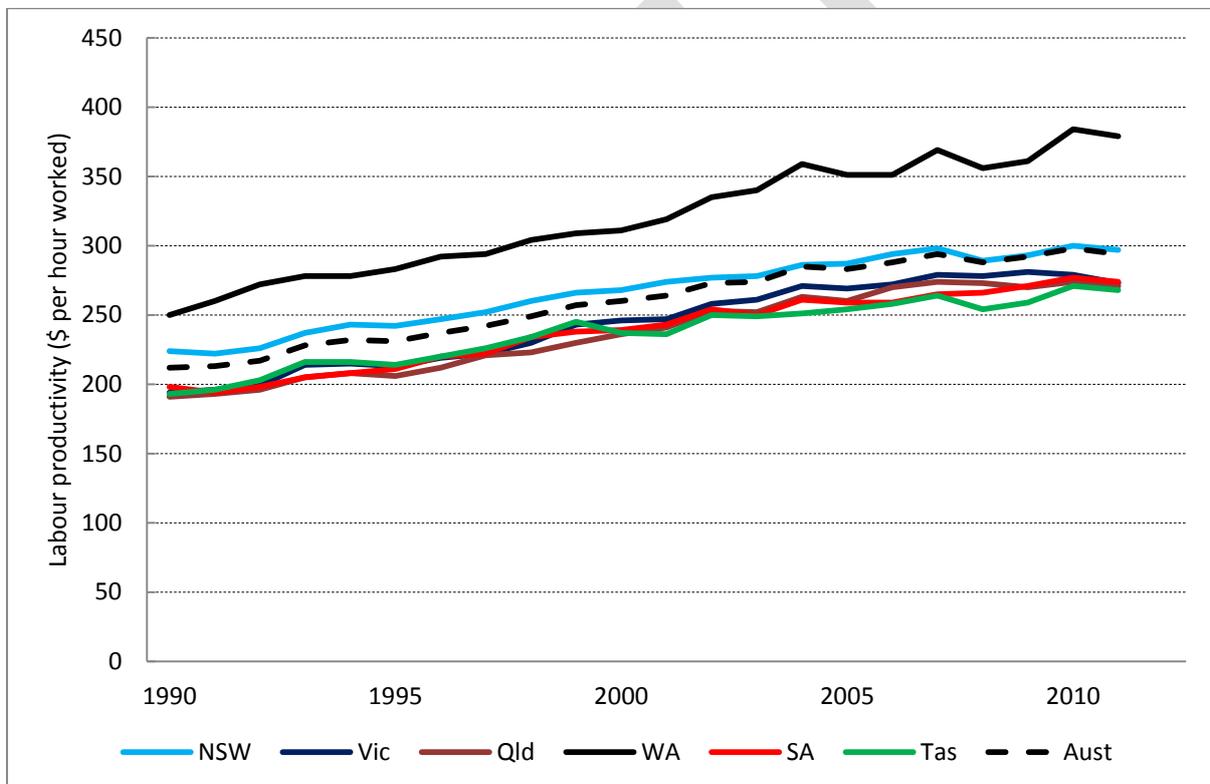
Source: ABS, Australian National Accounts: State Accounts, cat. no. 5220.0.

A key reason for South Australia's growth gap is its poor productivity performance

Productivity is a broad measure of the rate at which goods and services are produced per unit of input (such as labour or capital, or some combination of inputs). Growth in productivity is a crucial determinant of improved material living standards and, as American economist Paul Krugman famously put it, 'productivity isn't everything, but in the long run it is almost everything.'

Despite modest improvement in South Australia's aggregate labour productivity since the mid-2000s the state has consistently recorded productivity levels below the national average. Furthermore, South Australia has lagged behind Australia's leading productivity regions - Western Australia and New South Wales – for over two decades.

South Australia labour productivity below national average and leading states



Source: ABS, Australian National Accounts: State Accounts, cat. no. 5220.0; ABS, Labour Force, Detailed – Electronic Delivery, cat. no. 6291.0.55.001.

The use of aggregate productivity statistics masks the distinct possibility that some South Australian firms are, in fact, highly productive from national and international economic perspectives. Nonetheless, the crucial influence of productivity upon the attainment of material living standards implies that the state's policymakers should be mindful of the potential effects of their budgetary and regulatory policies on productivity growth outcomes.

The South Australian economy is weighted towards low-productivity industries

The South Australian economy is characterised by a complex economic structure of primary, secondary and tertiary private sector industries populated by firms with varying input mixes and trade relationships, as well as public sector entities which absorb and redistribute resources.

An analysis of the contribution of South Australia's industries to its state gross value added, compared with that of industries across Australia as a whole, reveals a host of distinguishing features concerning the state economy.

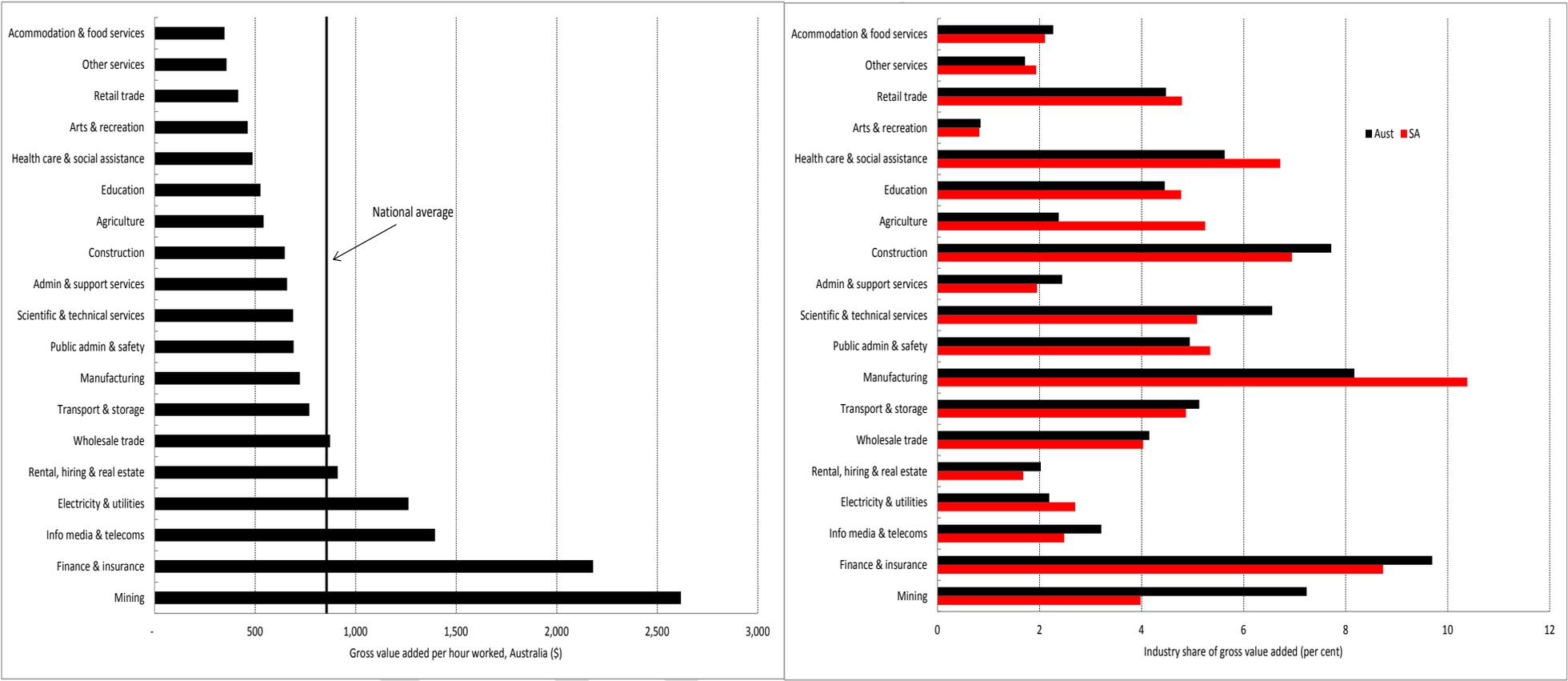
Agriculture and manufacturing each make a relatively greater contribution to gross value added in South Australia than that for Australia as a whole, whereas the relative contribution of mining in the state is appreciably lower than that for Australia more generally.

Another important characteristic of the South Australian economy is the relatively stronger contribution of public sector services, particularly in health care, social assistance, education and public administration, than that for Australia as a whole.

A comparison of South Australia's economic structure against labour productivity outcomes within various industries suggests that the state is over-represented by low-productivity industries, within the public sector and private industries such as agriculture and manufacturing, and under-represented by high-productivity industries such as mining, financial services and information media and telecommunications.

While there is little that the state government can do to alter the industrial composition of a primarily market-based economy, reforms should be undertaken with a view to reducing its involvement in the funding of low-productivity industries thus enabling resources to more readily flow to higher valued uses.

South Australia overrepresented in low-productivity industries



Source: ABS, Australian National Accounts: State Accounts, cat. no. 5220.0; ABS, Labour Force, Detailed – Electronic Delivery, cat. no. 6291.0.55.001..

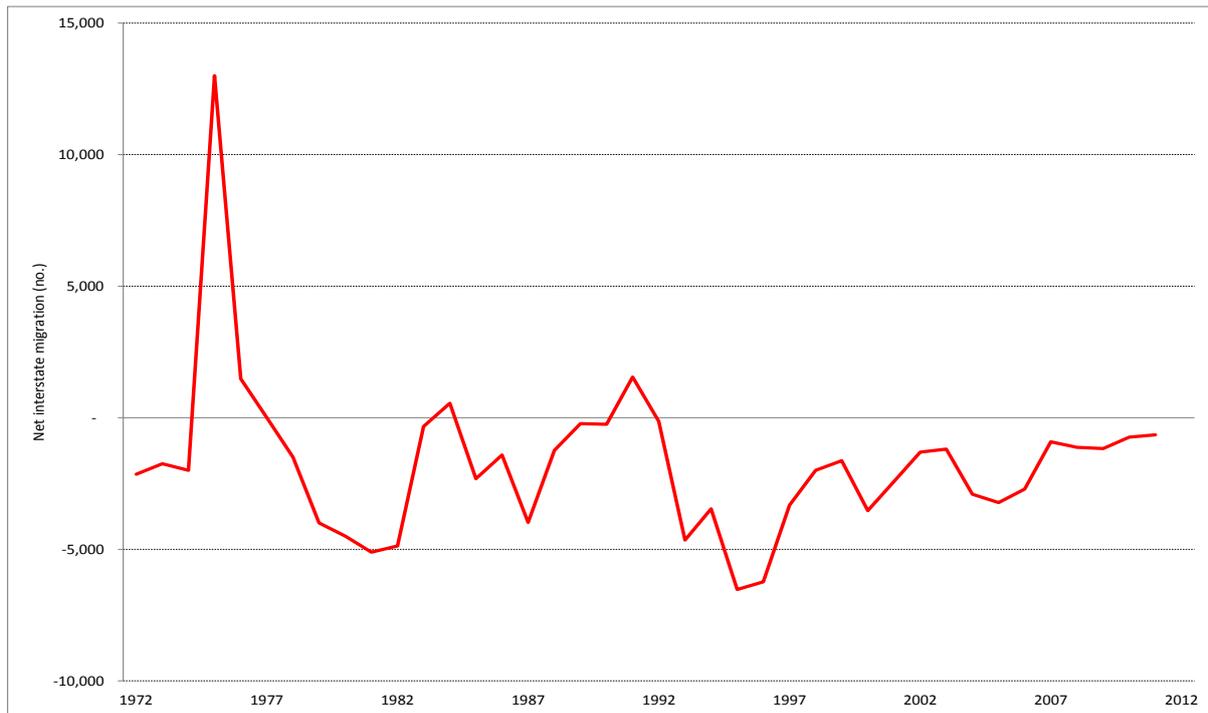
South Australia is losing people to other states ...

Lucrative economic opportunities in other parts of Australia, together with reduced transportation and relocation costs, has contributed to a consistent process of exit by thousands of people from South Australia on an annual basis.

Prior to the late 1970s, South Australia experienced significant fluctuations in net interstate migration with as many as 13,000 people moving to South Australia in 1975 alone. However, the effect of Queensland's abolition of death duties in the late 1970s and recessions during the 1980s and 1990s contributed to sharp increases in the numbers of people leaving the state.

During the 2000s there has been a consistent outflow of South Australian residents to other parts of Australia, especially the eastern states. However the average number of people leaving South Australia per annum over the past decade (1,600 people) is about half the annual numbers leaving during the previous decade (3,400 people).

South Australia losing some of its best and brightest talents interstate

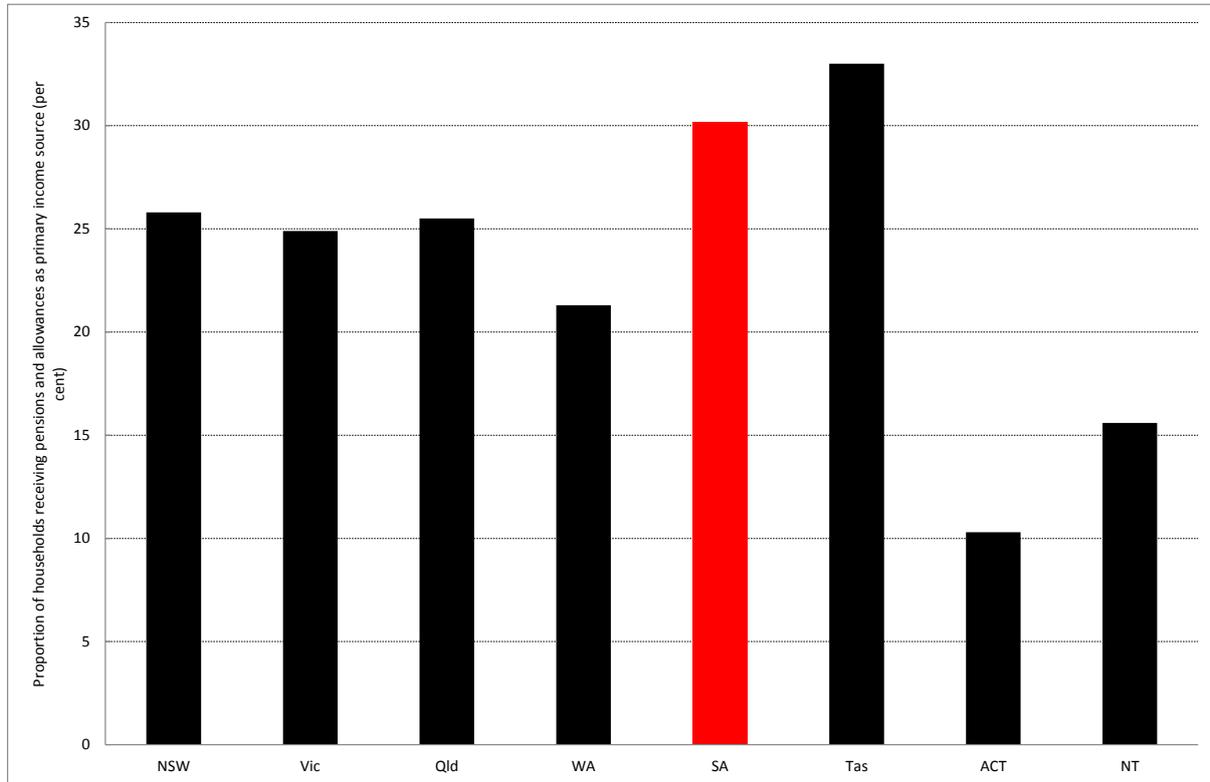


Source: ABS, Australian Demographic Statistics, cat. no. 3101.0; ABS, Australian Historical Demographic Statistics, cat. no. 3105.0.65.001.

... and too many of those left behind have become reliant on welfare handouts

Data provided by the Australian Bureau of Statistics shows that 30 per cent of South Australian households were dependent upon government pensions and allowances as their primary source of income in 2009-10. This was the highest share of welfare-dependent households on the Australian mainland, and the second highest overall after Tasmania (33 per cent).

South Australian households highest rate of welfare dependency on the Australian mainland



Source: ABS, Household Income and Income Distribution, Australia, cat. no. 6523.0.

A comparison of taxes paid and social security payments received by households also shows that households in South Australia, on average, have received more in social security payments than they have paid in taxation since the 'global financial crisis.'

Numerous studies have shown that the welfare state is associated with a range of adverse economic and social consequences. These include a reduction in labour supply as welfare recipients disengage from the workforce, a loss of work-ready skills and aptitudes the longer that people receive passive welfare payments, relative income inequality as welfare recipients miss opportunities to earn rising incomes from gainful employment, and loss of social connections and self-esteem.

While most welfare payments are provided by the commonwealth government, the relatively high degree of welfare dependency in South Australia underlines the importance of policy reforms at the state level to help engender robust economic growth and jobs creation.

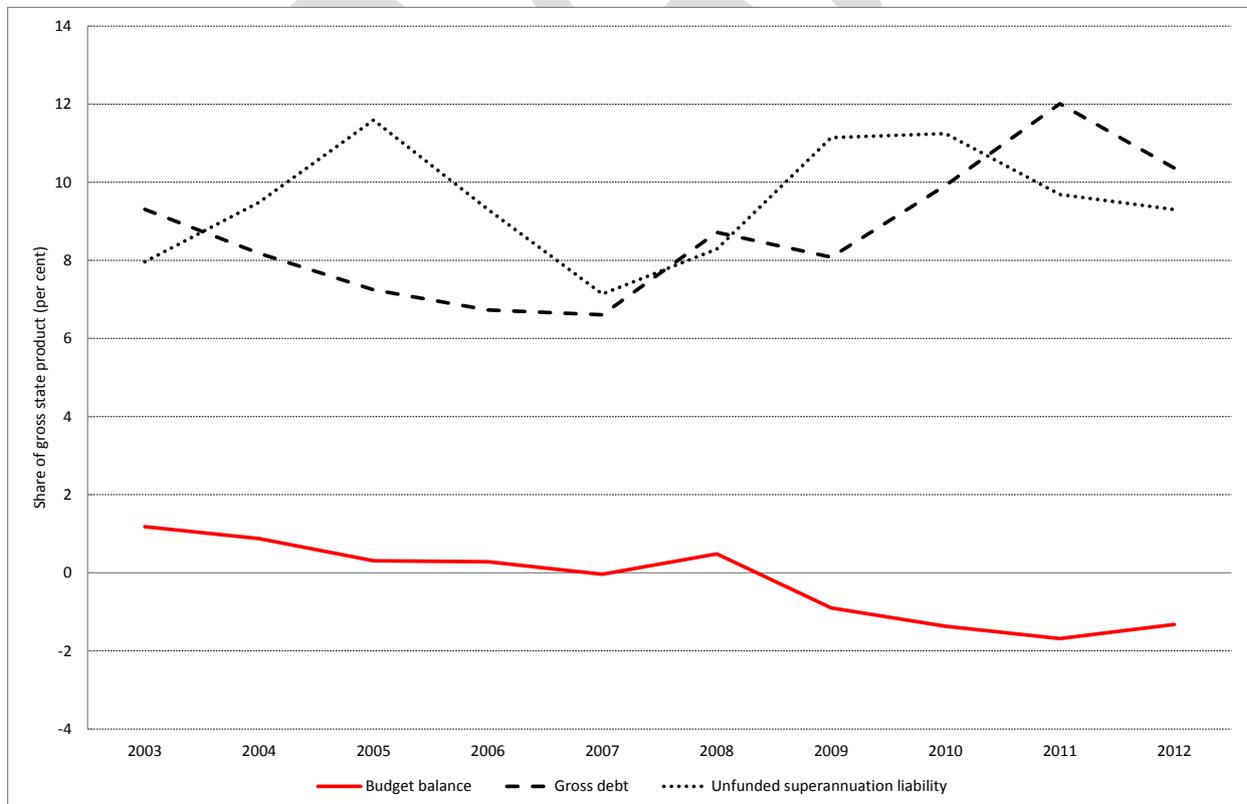
The state government has become so large and unfocused that it cannot pay its bills

Modern Australian state governments, whose politicians are accustomed to provide or fund aboriginal education to zero waste programs and seemingly everything in between, are prone to significant budgetary pressures should their revenues not exhibit sufficiently strong growth to cover their wide array of spending preferences.

South Australia has been particularly susceptible to periodic bouts of fiscal ill-discipline, as shown by the succession of state budget deficits since the onset of the global financial crisis. The excess of recurrent spending over revenue has spilled over into already high levels of gross debt, the proceeds of which must be repaid by future cohorts of taxpayers from a relatively narrow and inefficient taxing base.

Whereas there have been significant increases in spending on politically popular functional areas such as education, health care and welfare services over the past decade, the current South Australian government has continued to preside over extensive and unfunded superannuation liabilities. The government has indicated that these liabilities will be fully funded by 2034, long after the careers of most of the current crop of state politicians have expired.

A less than beautiful set of budget numbers



Source: ABS, Australian National Accounts: State Accounts, cat. no. 5220.0; South Australian Government, Budget Papers.

South Australia has become increasingly reliant on other Australians to bankroll its spending

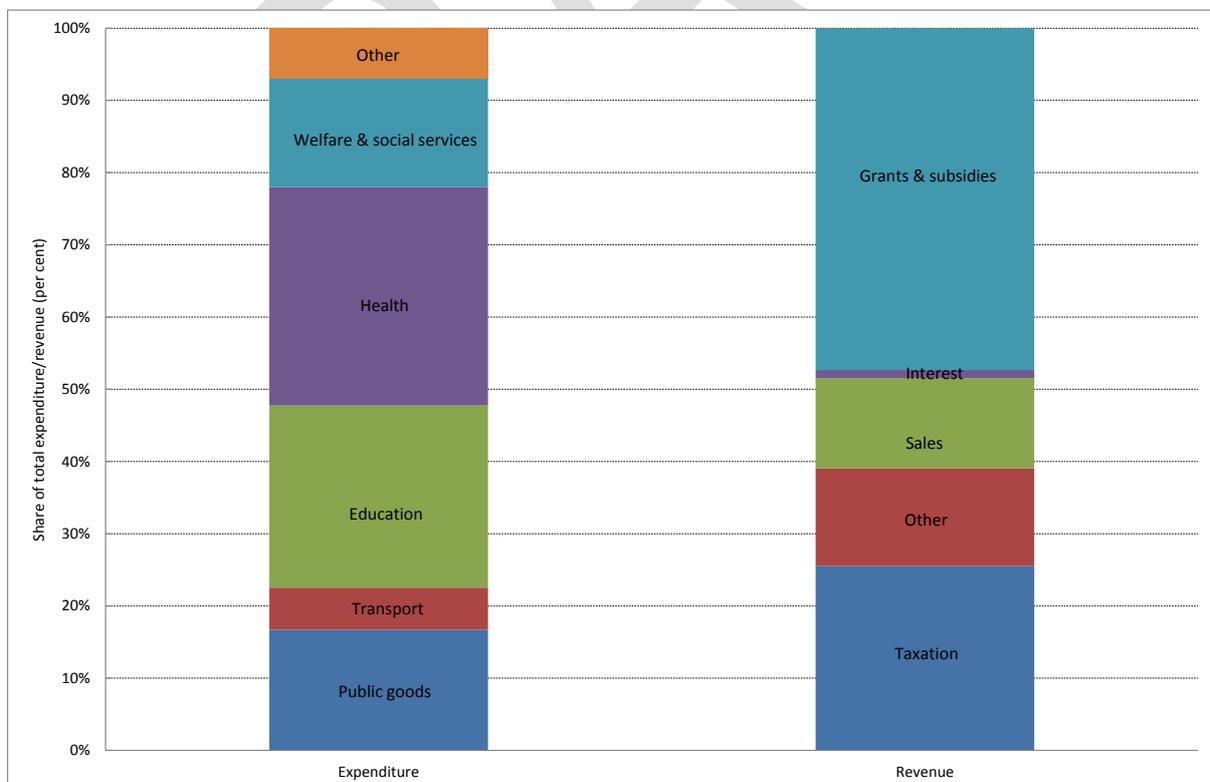
While the state government has made some welcome reductions in government spending at the margins, it continues to gamble on a return to buoyant economic growth to bolster its revenue collections and thus keep its excessive levels of spending intact.

Apart from risks to the economic growth outlook which could stymie the government’s ambitions to collect sufficient revenues, it should be borne in mind that South Australia does not fully fund its existing suite of expenditure activities in any case.

The payroll, property, gambling, insurance, motor vehicle and other taxes imposed by the state government barely cover basic public goods, such as public order and safety services, and transportation. Non-tax sources of own state own revenue, including sales of goods and services, interest income and other revenues, mainly cover the South Australian government’s education expenses.

Commonwealth grants, including untied GST revenue payments, represent about 47 per cent of the South Australian revenue base, and effectively cover health care, social welfare benefits and services, and a range of other expenses including ‘corporate welfare’ industry policy programs.

Other Australians are paying about half of the South Australian government’s spending



Source: ABS, Government Finance Statistics, cat. no. 5512.0. ‘Public goods’ defined as general public services, public order and safety, public debt transactions, and nominal interest on superannuation.

In Australia's distorted federal system the commonwealth government maintains monopoly control over the major revenue-raising instruments, including personal and corporate income taxes and sales taxes on goods and services.

Prior to the take-over of income taxing powers by the commonwealth in 1942, South Australian taxation revenue was almost three times as great as grants revenue received from the commonwealth. Today, the amount of taxes collected by the state government is a little over half the total amount of untied and tied grants revenue received.

The growing influence of commonwealth funding in South Australia's government revenue mix has progressively eroded away the financial and policy independence of the state government. Long term solutions which decentralise taxing powers will be necessary to ensure that South Australia, and other states, are able to reap the growth revenue 'dividends' of unilateral economic reforms they undertake.

DRAFT

South Australia is facing numerous economic and fiscal challenges, but the good news is that it can get out of its funk ... and it must

Although the realisation of South Australia's economic potential is hampered by lagging growth and productivity, government budget deficits and debt created by excessive spending, and the loss of human capital to other parts of Australia, the capacity of the state to erode its economic disadvantages is still achievable through reforms focussed on unleashing entrepreneurial talents, opening new markets and reducing the size and scope of government.

Consider the potential improvements in living standards for all South Australians that could arise from reform. If the state had invoked a range of economic reforms that lifted its labour productivity performance to the national average, the South Australian economy would have generated a cumulative \$60 billion in additional income since 2002-03.

Despite the prevailing sense of gloom following the Olympic Dam decision by BHP Billiton, South Australia retains a sound platform upon which to grow and prosper.

South Australia still possesses a vast bounty of mineral resources, with the Olympic Dam site alone estimated to contain one-third of the world's reasonably assured uranium resources along with a substantial copper endowment. The state also maintains a plentiful stock of quality land suitable for high quality agricultural production, as South Australian globally recognised viticulture industry attests.

It is widely anticipated that, under the right policy conditions and other circumstances, South Australia will be well positioned to capitalise on expected long term growth in the agricultural and mining sectors.

With a highly skilled workforce, and low office establishment costs from an international perspective, South Australia is also well positioned to attract viable manufacturing and services industries without the need for 'corporate welfare' industry assistance from the state government.

While it is possible to conceive of South Australia as a future global economic contender, it cannot afford to rest on its laurels or potential alone as it has done in the past. Indeed, other regions around the world are not holding back in efforts to improve their competitiveness and reform their economic institutions in efforts to attract globally footloose factors of production.

In the United States businesses and people are flocking to states which have explicitly pursued low-taxation policies, such as Texas, and are moving in droves away from high-taxing jurisdictions such as California and New York. Studies have shown that states without income taxes have enjoyed faster economic growth rates than states with the highest income taxes, as well as stronger employment growth outcomes.

US states are also experimenting with constitutional or statutory rules to limit the growth of their governments, providing more room for their private sectors to thrive.

Most of these rules seek to cap revenue or spending growth to overall growth in state income, or population growth plus inflation, and have also implemented strict budget balance rules. Perhaps the best known of the state fiscal rules come in the form of Colorado's Taxpayer Bill of Rights (TABOR) legislation, in which revenues in excess of the growth limits are refunded to taxpayers.

The United States is presently standing atop a substantial 'shale oil boom,' centred in the small Midwestern state of North Dakota. As a result of the boom, North Dakota has enjoyed economic circumstances not associated with the contemporary United States – an economy characterised by strong economic growth and low unemployment.

There have been numerous factors which have influenced the upturn in exploration and development expenditure in the American shale oil industry, including fewer regulatory burdens associated with mining activity on non-public land reserves. The experience of North Dakota and other American states with substantial shale oil production could provide some lessons concerning how to unlock mining sector growth in South Australia.

Reform of local government is also likely to be important in future policy efforts to restrain the economic burdens and costs associated with government activity. In the American town of Sandy Springs, Georgia, most services traditionally assigned to local government have been outsourced to private consortia or non-government entities. Studies have shown that costs in that locality have been reduced and service efficiencies increased when compared to traditional municipalities.

According to conventional spatial economic theories, the key to long term physical and human capital attraction is to ensure that the costs of immobile government are kept to reasonable proportions. This in turn ensures that mobile production factors are best able to attain satisfactory rates of return from economic activities they undertake in a given jurisdiction.

With other national and subnational governments around the world seeking to reduce their tax burdens, streamline regulations and constrain inefficient spending over time, the key to the economic renaissance of South Australia in the long run is to leapfrog other Australian and international jurisdictions in undertaking similar efforts.

By embracing these reform principles, private sector entrepreneurship will thrive generating new ideas of economic value to customers around the world, drawing in new investments and people to create a new sense of dynamism, creating new jobs which build thriving communities, and building a new South Australian society with a cosmopolitan, confident outlook in the face of new opportunities and challenges.

Now it's your turn, South Australians, to discuss your future direction

For all the economic and fiscal challenges the state presently faces South Australians have a lot of reasons to have pride in their state - from an institutional path-breaker in the past to a potential global economic powerhouse of food, resources and ideas in the future.

2012 may be viewed in many quarters as South Australia's economic 'annus horribilis,' but the run of outs are not necessarily inevitable. To ensure that the state gets back on its economic feet and powers ahead in the twenty-first century requires nothing short of a dedication to the principles and, indeed, practice of global economic competitiveness by all sections of the community, regardless of where they live within the state.

Residents of the state need to ask themselves some fundamental questions: do they want to enshrine South Australia as the best place to live, work and invest on the planet, without exception? Or are they satisfied to merely manage the current state of decline, drifting into economic irrelevancy at the edge of global economic space?

Although the next state election is due in 2014, South Australians don't need the political permission of an election campaign to speak up about their hopes and aspirations for their state. To this end, this paper is designed to encourage discussion by all interested members of the community - from Ceduna to Mount Gambier, from Adelaide to Oodnadatta - about South Australia's future economic directions conducive to transformative growth and development.

Questions for discussion

You are invited to respond to the following questions for discussion and, if you wish, may provide any other comments or feedback relevant to economic or fiscal policy reforms or economic competitiveness matters affecting South Australia.

- What do you see as the main contributors to South Australia's low growth and productivity over the past two decades? How have the contributors you have chosen led to the poor economic performance of the state?
- Are there any specific taxes or regulations, either at the state or local government level, which impede the growth of business and economic development in the state more generally?
- Are there any state or local government activities or roles that you believe should not be undertaken? If so, specify which activities or roles should be eliminated.
- What role have commonwealth government policies played in the performance of the South Australian economy over the last two decades? What kind of reforms would be necessary at the federal level to promote investment and jobs growth in South Australia?
- Has local government in your area played a constructive role in the development of the local economy? Are there any specific local government regulations, taxes or charges that you can nominate which affect business development?

You are welcome to provide your comments and feedback in response to these questions, and any other aspects of this paper, to lbevege@ipaprojectsa.org.au.

About Project South Australia

With the right policy framework the South Australian economy will thrive in an era of globalised investment and jobs mobility. Under the right circumstances, South Australia can become the best place to live, work and invest in the world. But to realise this ambition of prosperity for the state, a transformative economic and fiscal reform agenda needs to be identified and implemented.

Project South Australia is being undertaken by the Institute of Public Affairs (IPA) on behalf of a coalition of South Australian business representatives concerned for the future direction of the state. The IPA has an unrivalled policy track record of policy reform impact, including its pivotal role in the development of Project Victoria in the early 1990s inspiring the Victorian Kennett government reform program.

Project South Australia will comprise a number of research papers on economic and fiscal reform issues, with the first paper expected to be released by March 2013.

About the author

Julie Novak is a Senior Fellow at the Institute of Public Affairs. She has previously worked for commonwealth and state public sector agencies, including the Commonwealth Treasury and Productivity Commission. Julie Novak has published over 100 opinion pieces on issues ranging from state government finances to social services reform, published in *The Australian*, *Australian Financial Review*, *The Age*, *Courier Mail*, *Canberra Times* and *Adelaide Advertiser*.