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Centre of Full Employment and Equity

A Critical Appraisal of the Western Australia Budget 2012-13

Professor William Mitchell

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Centre of Full Employment and Equity
Charles Darwin University, NT Australia
Home Page: http://e1.newcastle.edu.au/coffee
Email: coffee@newcastle.edu.au

Terms of Reference

The Western Australian CPSU commissioned the Centre of Full Employment and Equity, at Charles Darwin University and the University of Newcastle, who are acknowledged experts in the field of public finance analysis, to provide an independent appraisal of the current fiscal strategy deployed by the Western Australian government.

Specifically, the research was to:

- Provide a framework for evaluating fiscal policy at the state level.
- Discuss the specific 2012-13 Western Australian Budget from the perspective of this evaluation framework.
- Analyse the impacts of the pursuit of “efficiency dividends” on the capacity of the Western Australian public service to deliver first-class services to the citizens of the State.

Executive Summary

1. Introduction

- The Western Australian Government recently released an updated budget outlook in the form of its "Pre-election Financial Projections Statement" (Department of Treasury, 2013), which took into account the improvement in commodity prices and the slight appreciation in the Australian dollar since the mid-year review was published in December 2012.

- The updated estimates resulted in higher projected Net Operating Balances than were anticipated in the original 2012-13 Budget exercise and the mid-year review in December over the forward estimates period to 2015-16. Over the entire forward estimates period the cumulative gain in the Net Operating Balance is $1,082.6 million. By 2015-16, the Western Australian Treasury is projecting a $1.7 billion dollar Net Operating Balance. That is, it is running a fiscal strategy that willingly intends to overtax the state relative to expenses by $1.7 billion or 0.62 per cent of projected Gross State Product. That is, an extraordinarily large net withdrawal.

- It is also clear that the Government is planning to maintain a tight control on expenditure and will achieve that, in a significant way, by imposing so-called efficiency dividends and staffing caps. This implies that there is scope to achieve improved productivity gains without compromising the quality and scope of the functions under scrutiny. There is a large and convincing literature that shows that attempting to save outlays by unproductive cost cutting is self-defeating. There is already sufficient evidence to demonstrate the lack of significant improvement in service delivery as a diminishing staff complement struggle to cope with the conflicts involved with increased demand for their services and a cumulative cuts to agency budgets.

- Even if there had been scope for improvement in the past – the assumption that cumulative cuts will continue to generate on-going improvements is demonstrably flawed. None of the justifications offered by the Government for stretching and undermining the capacity of the public sector to fulfil its basic raison d'etre – that is, to deliver high quality service to the citizens of Western Australia - are sustainable.

- First, there is an implied but unexplained prudence in achieving certain financial outcomes such as surpluses and reduced net debt independent of the size of the economy. These financial ratios have become ends in their own right. However, sound practice indicates that they must be interpreted relative to the basic functions of the government. The government doesn't exist to run surpluses. It exists to provide first-class services across a broad range of areas. That will typically require it to run balanced recurrent budgets to avoid it overtaxing the current generation or spending less than is required to fulfil its basic goals.

- Further, while commodity prices are volatile and royalty revenue does fluctuate, that has always been the case and there is no evidence that buffers of the size projected are an optimal way to meet this volatility. It is also the case that other revenue sources (such as GST receipts from the Commonwealth) are likely to be inversely related to the royalty income, thus attenuating the alleged revenue volatility.

- Finally, the striking aspect of the Western Australian Government's fiscal strategy is that it considers it appropriate to, at least partially, but increasingly, fund the State's Asset Investment Program from operating surpluses and any departure from that situation is considered to be a source of concern. Any strategy that seeks to fund capital investment from recurrent revenue violates basic public finance principles relating to efficiency and intergenerational equity. There is no justification in the broad economics literature on optimal budget practice that justifies such a strategy. The correct fiscal strategy is to fund all recurrent liabilities (such as interest payments on debt) from current income and spread the costs of infrastructure investment across time in proportion to the temporal distribution of benefits generated by the infrastructure. The vehicle for correctly matching intertemporal costs and benefits is public debt.

- By issuing debt, the Government ensures that the current generation does not endure disproportionate costs for benefits that future generations will receive The costs to the current generation of this strategy manifest as higher than necessary tax burdens and/or diminished scope and quality of services. Neither is warranted and both are totally avoidable if correct fiscal practice is deployed.

2. A framework for evaluating fiscal policy choices and outcomes

2.1 Introduction

- Fiscal strategies entail setting targets for net operating balance and net debt target, along with other objectives. Adherence to neo-liberal fiscal strategy dictates that governments strive to achieve what is now referred to as fiscal sustainability, which is normally defined in terms of achieving some narrow and arbitrarily defined financial ratios – such as budget surpluses and minimising net debt.
- The alternative approach, which delivered full employment for 30 or more years following the Second World War was to define fiscal sustainability in terms of the responsibility of governments to ensure that the spending gap left by non-government saving was filled with deficit spending. A sustainable fiscal position was one that supported sufficient spending growth to ensure there were jobs for all those who desired to work.
- The past three decades have witnessed fundamental changes in the conduct of fiscal policy. Reversing the trend up to the mid 1970s, governments have sought to reduce real income support benefit levels and eligibility criteria has been tightened to minimise expenditure. Spending on direct service provision has failed to expand in line with need. Moreover, the funding burden has shifted to low- and middle-income earners through increased reliance on indirect taxes such as the GST and significant reductions in company and income taxes, particularly for high-income earners.
- In Australia, Commonwealth and state governments embarked on fiscal consolidation from the 1980s. In order to overcome popular opposition to reductions in public services, or the failure to expand services to meet need, governments have argued that the gravity of the fiscal situation is such that there is no alternative. Governments have also split consumer groups by promoting private alternatives such as private education and private health insurance, that leave the more disadvantaged reliant upon the public sector.
- The ability of governments to constrain spending has been enhanced by the introduction of fiscal rules that specify various fiscal targets to ensure "fiscal sustainability":
    - Net operating balance: achieving balance or a surplus in each year or over a period of time; or achieving a surplus of a certain size which may be specified as an actual amount or a proportion of GSP;

- Use of recurrent funds to finance capital investment strategies thereby violating basic intergenerational equity;
- Net Debt: to reduce net debt by specified amounts; to maintain negative net debt; to ensure net debt remains below a proportion of GSP;
- Maintaining a particular credit rating or regaining a higher credit rating;
- Limits on total expenditure in absolute or relative terms; and
- Revenue rules that limit revenue raising or growth rates, with a view to maintaining competitiveness.

2.2 Understanding budget outcomes

- An important point that is overlooked when governments attempt to narrow their fiscal capacity by imposing arbitrary rules, such as balancing the budget over the economic cycle or running continuous surpluses is that the actual budget outcome that eventuates each year (or period) is not solely determined by the discretionary fiscal stance of government. The final budget outcome is in an important way determined by a range of factors that include wider economic conditions that are beyond the immediate control of federal and state governments.
- In that sense, trying to impose arbitrary fiscal rules, which limit the responsiveness of government fiscal policy to changing circumstances, is likely to be a failed strategy. The imposition of fiscal austerity in many nations at present is seeing their real sectors collapse but the financial ratios the governments are targeting move in the opposite direction to that desired.
- In terms of a state government– the Net Operating Balance - is the difference between total state revenue and total state outlays. So, if total revenue is greater than outlays, the budget is in surplus and vice versa.
- Many observers and politicians use the actual reported budget balance to indicate the fiscal stance of the government. So, if the budget is in surplus they conclude that the fiscal impact of government is contractionary (withdrawing net public spending), and if the budget is in deficit, they conclude that the fiscal impact is expansionary (adding net public spending).
- However, the complication is that we cannot then conclude that changes in the fiscal impact reflect discretionary policy changes. The reason for this uncertainty is that there are automatic stabilisers, which are in-built into the budget outcome and vary with the level of economic activity independent of discretionary policy changes.
- When the economy is weak, tax revenue falls and welfare payments rise and so the Budget Balance moves towards deficit (or an increasing deficit). When the economy is stronger, tax revenue rises and welfare payments fall and the Budget Balance becomes increasingly positive. Automatic stabilisers attenuate the amplitude in the business cycle by expanding the budget in a recession and contracting it in a boom.
- There was a major cyclical decline in tax revenue available to the Western Australian government as a result of the GFC.
- As a result, we cannot conclude that a rising budget deficit indicates that the State government has suddenly become of an expansionary mind. An important point to understand is that the actual budget balance is to a major extent, out of the control of the state government because the cyclical component reflects the variations in the spending decisions of private sector agents (household, business firms, external relations). As a result, it is often counter-productive for a government to attempt to cut back the budget outcome with discretionary spending cuts and/or taxation increases because it fears the budget balance is excessive.

- In these circumstances, the imposition of austerity may then cause State Product to contract and the automatic stabilisers (principally, tax revenue at the State level) to push the budget further into deficit. It also follows that a growth strategy underpinned by discretionary stimulus spending and/or tax cuts can drive reductions in the budget deficit outcome as the level of economic activity increases and tax revenues recover.
- We thus urge caution when dealing with discussions surrounding the dynamics of a state budget and efforts have to be taken to decompose the structural and cyclical components of the actual reported budget outcome before any analysis of the discretionary fiscal stance is engaged. It is impossible to make any sense of the appropriateness of the fiscal stance of the state government without first undertaking this decomposition.

2.3 Funding the capital budget

- The net operating balance is the difference between recurrent revenue and spending. Net public investment is the sum of purchases of non-financial assets less sales of the same less depreciation plus change in inventories plus incidentals, which are typically zero.
- The sum of the net operating balance and net public investment is equal to how much the government had to borrow in the given fiscal year.
- One of the characteristics of the neo-liberal period has been an aversion for state governments to use debt to underpin the development of productive public and social infrastructure. In the full employment period prior to the 1980s, governments used debt to fund non-recurrent expenditure because they knew this allowed the costs and benefits of large-scale investments to be temporally matched in an efficient and fair manner.
- Under the neo-liberal fiscal mentality that now dominates, state governments aim to run surpluses on the operating account of sufficient size in order to use the excess of revenue (mostly taxes) over recurrent spending to fund public infrastructure investments and/or pay down outstanding net debt.
- Very little evaluation has been done on the consequences of this policy shift despite this approach being a defining characteristic of the fiscal strategy employed by the Western Australian government.
- What is wrong with this fiscal behaviour? Quite apart from whether the structural budget outcome provides an adequate degree of expansion, the strategy employed by the Western Australian government, both undermines the scope and quality of recurrent services that can be provided and also violates reasonable rules of intergenerational equity.
- Running recurrent surpluses that are greater than net public investment (and thus paying off debt) forces the current generation to pay for the benefits of a later generation in the form of higher than necessary taxes or lower volume and/or quality of services.
- Economists adopt what is called the "golden rule" when it comes to financially constrained governments and their capital expenditure. The Western Australian government is financially constrained because it does not issue its own currency. In that sense, unlike the federal government, state governments have to fund their spending with a mix of taxation and bond issuance.
- The golden rule relates to the observation that sound fiscal practice requires the government to match the burden of the costs of public infrastructure provision with the temporal profile of the benefits that the infrastructure delivers. Long-lived capital delivers benefits to future generations. It is considered only equitable if the costs incurred in providing those benefits are correctly matched.
- Equity is achieved by targeting balanced recurrent budgets net of capital spending, but recognising the need for and inevitability of recurrent deficits when non-government spending is weak and employment growth is declining. In that context, there will

sometimes be a need to use borrowing to fund recurrent services and other operating expenses. That is a sound strategy if it is pursued in a counter-cyclical manner.

- In addition, the achievement of equity also requires that capital expenditure should not be funded from current taxation as a means to avoid borrowing. State governments have fallen prey to the spurious argument that if they resist borrowing they will ensure the rating agencies reward them with AAA ratings. However, this is an irrational strategy because the only purpose of a AAA rating is to reduce the cost of borrowing. In that context, borrowing should fund capital expenditure and the servicing costs then prorated over the life of the asset by a claim on recurrent revenue.
- The Western Australian government's fiscal strategy appears to be inconsistent in this regard. It seeks expanding Net Operating Surpluses to fund an increasing proportion of its capital works program, which violated the fundamental Golden Rule principle of public finance. This violation not only imposed unfair burdens on the current generation but their fiscal conservatism has also seen a reduction in the rate of capital infrastructure development, a problem they are now having to face as essential capital works are necessary.
- The Western Australian government has not exhausted its borrowing capacity. The thirst for sovereign debt in a climate of increasing risk is very high and will continue so for decades to come. The new prudential requirements that the Bank of International Settlements have defined and which the Reserve Bank of Australia has supported as a reasonable operating environment for our commercial banks to work within also ensure that the demand for zero risk (Australian government debt) or extremely low risk (State government debt) will remain strong for years to come.
- Further, the tax base of the Western Australian government is robust and will expand with the growth in the economy. There is no sense that it is imposing unfair or unaffordable burdens on the future generations.
- In fact, its ambitious public infrastructure investment program will improve the fortunes of the future generations and open up more options to them. If the Government adopted the Opposition's plan to fund all capital works out of recurrent revenue by savings - which means cuts in other recurrent programs - then it would be unreasonably punishing the current generation and in all probability undermining the future potential of the economy and the next generations (by starving current services).
- Further, the ratings agencies should not be used as benchmark for defining fiscal prudence. They lost all credibility in the lead-up to the GFC by fraudulently providing the highest ratings to assets they knew were of inferior quality and were at a high risk of failing.
- It is clear in the case of Western Australia that Moody's is seeking, like the Labor Party, to violate the Golden Rule of public finance - that the costs and benefits of government service and infrastructure spending be correctly matched over time.

3. Fiscal strategy and outcomes: Western Australia

3.1 Background to current fiscal strategy in Western Australia

- The current fiscal strategy was set in train after the 1991 recession by the Lawrence ALP government. In 1992, they defined a strategy for Western Australia which emphasised: containing increases in total state debt to at least 1 per cent less than economic growth (on average); repayment of debt; and, regaining the Triple-A credit rating in the medium term.
- The incoming Court Liberal-National Government (1993-2001) continued to prioritise debt reduction and surplus budgets. The Government Financial Responsibility Act 2000

established principles that included: funding current services from current revenues; spending and taxing policies that ensured stability and predictability; and prudent management of financial risks.

- The Labor Governments of Gallop (2001-2006) and Alan Carpenter (2006-2008) maintained this fiscal stance and sought to achieve net operating surpluses and reduce debt. The Government undertook to implement election promises through savings, such as, a reduction in the number of ministers; cuts to spending on advertising and consultants, the introduction of a 'priority dividend' that grew from 1.5 per cent of agencies' total operating expenses in 2001-12, to 2 per cent in subsequent years and then a further $50 million per annum. Some frontline services including health, education, police, community development and the Disability Services Commission were exempt from the priority dividend.
- Throughout the term of the Labor Governments, surpluses were used to fund capital investments thus violating the Golden Rule of public finance. New spending initiatives and tax relief were also provided.
- The current Barnett Liberal Government took office in 2008 and cited the declining economic situation at the time associated with the Global Financial Crisis as the motivation for a 3 per cent efficiency dividend and caps on public sector staffing in the 2009-10 Budget along with other savings measures while maintaining the long-standing fiscal strategy and targets with some amendments.
- The new targets replaced the former net debt to revenue ratio target with a net debt affordability ratio (as measured by net interest costs as a share of revenue). The general government expense target is now based on growth in wages.
- The 2010-11 Budget prioritised improvements in service delivery for key public services, infrastructure projects and the maintenance of surplus budgets allegedly to retain the Triple-A credit rating. The fiscal targets from previous years remained, except public sector interest costs were to be at or below 4.5 per cent of revenue (down from 5 per cent).
- The Government outlined the policies that had been introduced to reduce the rate of growth of expenses: a 3 per cent efficiency dividend; a new policy for public sector wages; a ceiling on staff numbers; and voluntary redundancy programs (469 packages from $48 million allocated in March 2009; around 300 in March 2010; and a further 400 announced in the 2011-12 Budget). Expenditure cuts were imposed despite the fact that the Government acknowledged that the demand for services such as health and education was increasing.

3.2 Recent developments in Western Australia

- Buoyant economic conditions in Western Australia due to the mining boom have spared the state from some of the fiscal problems encountered by other states in recent years. Western Australia has also experienced strong population growth that has stimulated the demand for public services.
- Growth in expenditure in staffing has been concentrated in frontline positions such as child protection, police and corrections staff, teachers and health professionals. However, significant expenditure and staffing cuts have also been a feature of Western Australian budgets.
- The incoming Barnett Liberal /Coalition Government established an Economic Audit Committee to examine the performance of the public sector. The 2008-09 Mid Year Projections Statement included a 3 per cent efficiency dividend that was allocated to all agencies from January 2009, which was 'integral to maintaining the State's financial health'. This measure was expected to deliver savings of $1.7 billion from 2009-10 to

2012-13 (Budget 2010-11). The efficiency dividend was subsequently extended to include a 5 per cent measure for Government Trading Enterprises from 2011-12.

- In the 2009-10 Budget the Government announced savings of $1.1 billion and foreshadowed further cuts after the final Economic Audit Committee report was released. In addition to the efficiency dividend, a ceiling on full-time equivalent staffing levels was imposed in general government agencies (Government of Western Australia, 2009). Further expenditure cuts were announced in the 2009-10 Government Mid-Year Financial Projections Statement to achieve total savings of $1.4 billion in 2009-10, and $8.5 billion over the four years to 2012-13. Further savings of $300 million announced in the 2011-12 Budget are to be achieved by reviewing existing programs.
- Large budget surpluses have enabled the Government to repay debt and fund some large infrastructure projects without recourse to debt financing.
- The Government has also outsourced a variety of services. Health promotion programs were outsourced to NGOs including healthy eating, diabetes awareness, anti-smoking campaigns and safety in the home (2007-08 Budget). Management of Acacia Prison was outsourced to SERCO in 2006. The value of child protection services outsourced to NGOs increased from $65.1 million in 2005-06 to $82.8 million in 2010-11 and continues to rise. Similarly grants to NGOs for disability services increased from $163.6 million in 2005-06 to $255.3 million in 2010-11. The value of per capita grants to private schools increased from $197.5 million to $316.8 million over the same period. Court security and custodial services and traffic infringement processing has also been outsourced.

3.3 Current fiscal outcomes for Western Australia

- In contrast to other states, revenue growth outstripped growth in expenses in Western Australia in the period from 1998-99 to 2011-12. Revenue growth averaged 8.4 per cent per annum while expenses increased at 8.0 per cent.
- Western Australia has consistently recorded net operating surpluses since 2000-01, with the largest surpluses achieved in the period immediately prior to the GFC ($2,508 million in 2007-08). During this period there has been considerable volatility in the $US iron ore prices as is shown in Figure 2. In the post-GFC period surpluses fell, as expected but current forward estimates predict a strong Net Operating Balance for the period 2012-13 to 2015-16.
- In the "Pre-election Financial Projections Statement" (Department of Treasury, 2013), which is the most up-to-date advice provided by the Western Australian Treasury (as of February 2013) predicted higher operating surpluses largely as a result of higher iron ore prices relative to the projections in the mid-year review.
- The WA Treasury also outlined various risk factors, which they claimed could wipe out those surpluses. At the forefront was the sensitivity of forward estimates to the volatility of iron ore prices. They outlined a strategy that increasing Net Operating Surpluses were required to provide "an appropriate buffer against adverse movements".
- It is unclear whether the WA Treasury considers the volatility will be greater than it has been in the past. There is no current evidence available to support that view.
- Further, it is unclear if the only variation they are making in the sensitivity analysis is in the royalty income as a result of a hypothesised change in the $US price of iron ore. For example, if royalty income dropped so markedly, what changes in Western Australia's projected GST relativity would result?
- While the Pre-election statement indicates that projected revenue growth will remain "significantly lower than the long-run average growth rate of 8.5% recorded over the last decade", it is questionable whether the entire last decade is a reasonable period on which to benchmark long-run revenue growth prospects. If we take the period before the boom

in commodity prices occurred – for example, from 1999-2000 to 2003-04, revenue growth averaged 7.3 per cent per annum. Over the same period, growth in expenses averaged 5.6 per cent per annum.

- The WA Treasury offers several reasons why revenue growth will average around 4.8 per cent over the forward estimates. The lower share of national GST is due to the strong royalty income that the Western Australian government is enjoying. Should the financial benefits from the mining boom languish and the relative financial position of Western Australia be impaired then reductions in the growth of GST grant income will be reversed. The other two factors identified by the WA Treasury are not enduring.
- On the expense side, the Department of Treasury (2013) assume that government spending will grow by an average 3.8 per cent over the next four years. In other words, even if we were to believe the overly pessimistic revenue forecasts to 2015-16, there is no major divergence likely to occur between expenses and revenue.
- Moreover, if the efficiency dividends are maintained and the employment caps that have been announced remain in place the growth in spending will be further reduced, opening up a wider gap between revenue and expenses.
- There is no coherent argument that can be made – in terms of maintaining prudent fiscal settings – for the on-going staffing cuts and cost cutting – given the current forward estimates.
- The WA Treasury (2013: 36) claims that increasing Net Operating Surpluses are required to "provide more of a buffer against increased revenue volatility, and to reduce the need for new borrowings to fund infrastructure investment". This strategy should be rejected. First, it is a poor debt management strategy to tie fluctuations in debt issuance on variability of commodity prices. Debt issuance should be based on long-term public infrastructure investment plans. Cyclical variations in debt issuance should be largely avoided at the state government level. Second, and more importantly, why is debt issuance to be minimised and the planned growth of debt to (largely) independent of the size of the overall economy and the economic and social returns expected to flow from the expansion of public infrastructure?
- One can agree, that at the state level, debt issuance to cover recurrent deficits would be a second-best option and should be avoided except in cases of an extreme cyclical downturn. But there is no economic case that can be made to justify either over-taxing or under-funding recurrent service delivery agencies and imposing staffing cuts, which demonstrably undermine productivity, in order to create a surplus that can be used to fund capital infrastructure development.
- It is clear that the Western Australian government has fallen prey to the errant thinking that is an efficient, long-term fiscal strategy to starve service delivery agencies of resources, thereby undermining the scope and quality of services to fund as much of its capital works budget as it can out of recurrent revenue.
- This approach to public finance not only undermines the prosperity of current citizens who have to endure diminished services and/or higher taxes and charges, but also violates intergenerational equity principles by forcing the current generation to bear a disproportionately higher burden of the costs of infrastructure provision, which will provide benefits for several generations to come.
- In the publicly-available documentation, there has never been a coherent intertemporal costs-benefit analysis presented by the Western Australian government, incorporating reasonable estimates of social costs and benefits, which shows the superiority of the current fiscal strategy relative to the more sensible economic strategy of funding capital investment from debt and balancing the recurrent budget.

- Further, there is growing evidence of the mounting costs arising from the loss of scope and quality of service delivery that have accompanied the obsession with minimising public debt and imposing efficiency dividends and staff cuts on service delivery agencies. These costs should be included in the Budget Papers alongside the other "risks" that the WA Treasury chooses to highlight. We provide a case study in Appendix A that shows that the risks associated with lapses of bio-security to an economy that still enjoys a strong contribution from its agriculture sector are high.
- The fiscal rules outlined in the Pre-election Update also bear no relation to the purpose of government. For example, there is no assessment of the loss of quality of services as a result of pursuing these rules. The implication is that the rules have meaning in their own right, which is the neo-liberal mantra. Fiscal rules formulated independently of social and economic goals (the real economy) defy the public purpose role of government.
- Further, the 2012-13 Western Australian Budget continued to expound the myth that there is significant scope to fund new recurrent initiatives from so-called "savings" generated by cost cutting. The nomenclature used in place of the negative sounding "cost cutting" is "efficiency dividends".
- There is no justification for the proposed "dividend" parameters other than the circular logic that a certain dollar end number was required and the percentage quantum for the dividends proposed achieved that end. The underlying assumption is that there is significant waste remaining in the public sector such that outcomes are not impaired by the loss of input. Extant research has failed to find evidence to support that presumption.
- Detailed analysis presented in Section 5 of this Report illustrates that the on-going efficiency dividends amount to nothing more than spending cuts to the service delivery capacity of the public sector in Western Australia. Combined with explicit cuts to specific programs, the ongoing efficiency dividends have reduced public sector staffing. The evidence suggests that arbitrary efficiency dividends have long since harvested available efficiency gains so that further cuts are reflected in increased stress for remaining staff attempting to provide high quality services in a constrained environment and this has a detrimental impact on both the quantity and quality of public services.
- The reasonable null hypothesis that draws on the available evidence is that the on-going cost cutting is now extremely damaging to the integrity of public service delivery in Western Australia.
- As a result, the on-going imposition of these efficiency dividends has to be questioned. The Government should be required to demonstrate their assessment of the impact of the cost cutting on the quality and scope of delivered services and to demonstrate why the vast evidence, which indicates that such strategies are undermining the capacity of the public sector to deliver such services is wrong.

4. The Western Australian Economy

4.1 Economic growth

- Since the onset of the Global Financial Crisis, the Australian economy has outperformed other major economies. In 2009-10 the national economy grew by 1.4 per cent compared to a contraction of 3.2 per cent in advanced economies. The Western Australian economy was a standout performer in this regard and grew strongly throughout.
- Since 2008-09, the Australian economy has averaged 2.4 per cent real GDP growth per annum and started slowing in 2011-12 as the fiscal stimulus was withdrawn. However, the Western Australian economy continued to grow, averaging 4.2 per cent per annum over the same period as commodity prices resumed growth after dipping in 2008-09.

- The Western Australian economy is enjoying a two-fold source of prosperity, which will underpin growth for several years. First, commodity prices have boomed. They are now moderating but still remain well above past levels. Second, there has been a massive increase in private capital investment in the mining sector in response to these record commodity prices.

4.2 Private Capital Formation

- Private capital formation growth in Western Australia has outstripped the national growth rate since the acceleration of commodity prices. In the immediate period, the commodity price boom and flow of private investment has driven the strong GSP growth.
- Once the construction phase is over, the higher output levels that will flow from the mining sector as a result of the extra capacity being built will provide for sustained state income gains for many years to come.

4.3 Commodity prices and the Western Australian economy

- It is clear that there is a strong cyclical element to the movement in commodity prices. While the Reserve Bank Base Metals series has been more volatile than the broader aggregate, both were relatively stable until late 2003, early 2004. The first commodity price boom pushed prices to record levels (the Base Metals Index peaking at 208.3 in May 2007) and was interrupted in 2007 by the onset of the Global Financial Crisis (GFC), which saw the Chinese economy slowdown for a time.
- The recovery in commodity prices after the downturn, largely due to the fiscal stimulus measures introduced by the Chinese government, saw prices peak at a lower level (164.2 in February 2011) than was experienced pre-crisis. Since that time the index has fallen and is currently stable at around 132.
- The commodity price cycle clearly benefitted the Australian economy in general, and the Western Australian economy, in particular. It boosted taxable profits in the minerals sector and spawned a massive investment cycle as mining firms sought to construct productive infrastructure in order to capitalise on the price boom.
- While the positive impact of the strong real GDP growth that accompanied the commodity price cycle on government revenue is clear, the Western Australian government is adopting a cautious line with respect to the future movement in commodity prices.
- There are two competing views on the direction of commodity prices. Are the shorter cycles associated with the GFC and the ensuing recovery period overlaying a longer cycle since 2004, which is incomplete? The implication of this view is that commodity prices will fall further and not establish a new, higher steady-state level. Alternatively is the rise in commodity prices, the GFC cycle notwithstanding, signalling a structural improvement in the terms of trade? The implication is that while the price level will moderate somewhat, a new higher floor level will be sustained and a new cycle will emerge from that level in the future.
- A comparison of the commodity prices expressed in US dollars relative to the prices in terms of Australian dollars shows that the USD series has scaled new heights in the recovery after the GFC. However, that is largely because the USD has depreciated against other major currencies and is therefore, largely, a valuation effect. Commodity prices in Australian dollar terms have been much more subdued.
- The growth in world commodity prices is the product of increasing demand from the industrialisation and urbanisation process in China combined with increasing supply constraints in the resources sector.

- While the commodity price cycle may have peaked now, it remains that the Chinese process of structural transformation has many years left to go and demand will remain strong.
- The question is how long the supply constraints that have been present over the last five years will persist. It is likely that the lagged response to the higher commodities prices will lead to higher supply capacity in the coming decade as a result of the major investment that resource-rich nations have made in building new infrastructure. While this will underpin strong income growth through export volume increases, the increased supply will temper any demand-pull influences on price.
- Further, there will be a shift from the investment spending that was required to construct the new supply capacity to export income. The net effects of these shifts are difficult to forecast but the outlook definitely remains positive for resource-rich economies such as Western Australia.
- The falling commodity prices in 1998-99 led to the decline in real GDP growth in Western Australia in that year and the following two years (with negative growth in 2000-01). However, the WA economy bounced back strongly in 2001-02 on the back of strong investment chasing the renewed commodity price cycle. The commodity price rebound since 2002 led to a catch-up in mining investment after the sharp reductions in productive capacity in the late 1990s. The investment cycle is now almost complete and increased output will sustain the WA economy for some years to come.
- The conclusion is that commodity prices are being driven by longer-term forces associated with the industrialisation and urbanisation of China, which will continue for many years to come.
- The volatility in the commodity price index will not be eliminated but the trend will remain very positive and it is unlikely that the level common prior to 2004 will be re-established.
- The current level is likely to moderate somewhat as the supply capacity improves as a result of the massive investment that has taken place over the last decade or so in the Western Australian mining sector.
- But as the prices received will decline, the volumes to meet the on-going demand from China will increase. While it is impossible to predict the net impact on Western Australian Gross State Product and income of these trends, it is highly unlikely that the economy will flounder in the ensuing future.
- We would advise against adopting fiscal austerity based on pre-conceived notions that commodity prices will collapse.

5. Public sector staffing developments

5.1 Introduction and 5.2 National Trends

- The Report summarises the work of Cook, Quirk and Mitchell (2012) who provide a detailed analysis of public employment trends in Australian states and territories.
- Between 1984 and 2011, a period where total employment grew by almost five million, public sector employment increased by only 235,400 (from 1,660,700 to 1,896,100) and its employment share declined significantly. Commonwealth employment declined in both absolute and relative terms, falling from 421,900 in 1984 to 251,400 in 2011. State and Local Government employment increased in absolute terms but at a much slower rate than total employment growth.
- The industry composition of public sector employment has changed dramatically over the past thirty years. Education, government administration and defence, and health and community services have dominated government employment, growing from 54 per cent

of public sector employment in 1983 to 86 per cent in 2011. Between 1983 and 2011 public sector employment increased from 342,700 to 591,200 in education, 277,700 to 598,500 in government administration and defence, and 268,800 to 431,400 in health and community services. Staffing reductions in transport and storage, electricity, gas and water, communication services, finance and insurance, and manufacturing reflect government privatisation policies.

5.3 State public sector staffing in Australia

- Despite the fact that all states have experienced some increase in public sector employment levels since 1984, the rate of growth has been substantially lower than the growth of total employment. In all states the growth in total employment has been greater than the growth rate for state public sector employment.

5.4 Overall labour market trends in Western Australia

- The Western Australian labour market has improved in performance since the recession of the early 1990s. Before the GFC, the unemployment rate was well below the national average. While it is still below the national average, the recovery has not yet been strong enough to return to its previous lower level.
- Since January 2000, total employment in Western Australia has grown by 44.5 per cent compared to the national average of 30.5 per cent.
- Western Australia has consistently higher participation rate than the national average. Most significantly, in the current period, even though participation rates fell in the state and nation as a whole with the onset of the GFC as job opportunities were scarce, the WA labour market has recovered while participation rates in Australia remain well below their previous peak.
- The WA labour market is generating strong employment growth but also facing much stronger labour force growth than the nation as a whole. In contrast, the unemployment levels in Australia overall are being held down by the fact that participation rates have fallen sharply, which means that official unemployment is lower than otherwise but hidden unemployment is higher.

5.5 State government employment in Western Australia

- Cook, Quirk and Mitchell (2012) provide a detailed analysis of public sector employment in Western Australia up to 2011. The annual growth in state public sector employment for the years spanning 2007-08 to 2011-12. Prior to 2010-11, growth in the Western Australian public sector was above the national average although the gap was slowing. Over the last two fiscal years, it is clear that contraction in public employment has been sharp in Western Australia.
- Further, in assessing whether the scale of the overall state public sector employment it is useful to analyse the number of public servants per 1000 population. It is expected that states with the largest population share will have a smaller number of public servants on a per capita basis due to scale efficiencies. We also have to take into account population density. As a result of the contraction in public employment in Western Australia, the number per 1000 persons is around that of South Australia and Queensland despite the fact that South Australia has a significantly smaller population than both these states. If the South Australian public sector is relatively lean, then this would suggest that the job cutting enforced as a result of the efficiency dividend in Western Australia has been excessive.
- The data shows that public sector employment growth rose by 44.6 per cent between 1984-84 and 2011-12. Over the same period the Western Australian labour force more

than doubled. By comparison, total public employment in Australia grew by 33.8 per cent while the labour force grew by 70.7 per cent.

- The Barnett Coalition Government introduced FTE ceilings in FTE staffing levels for General Government agencies and a 3 per cent efficiency dividend to apply from January 2009 (2008-09 Government Mid-Year Financial Projections Statement (Government of Western Australia, 2008). The Government also introduced a public sector wages policy from July 2009 that involved tying wage increases to the Perth Consumer Price Index. Any increases above the CPI were required to be linked to improved efficiency, with total increases (CPI plus efficiency) capped at the WA Wage Price Index for all sectors.
- The intention to cut public service numbers was re-affirmed in the 2012-13 Western Australian Budget. In the 2012-13 Budget, the Government announced further restrictions on public staffing despite noting the pressures on the provision of public services as a result of population growth.

5.6 The direct consequences of public employment cuts

- The logic of imposing efficiency dividends and growth caps public sector employment is that productivity improvements will allow the agencies to maintain the scope and the quality of service. All state governments in Australia have engaged in cutting public sector staffing due to self-imposed budget constraints. Staffing reductions are generally characterised as being in non-frontline areas, and therefore, have little or no impact on service delivery.
- Cook, Quirk and Mitchell (2012) provide the most detailed analysis to date in Australia of the consequences of such staffing strategies and conclude that there are a range of negative consequences that compromise the overall capacity of the public sector to meet its responsibilities.
- In an environment of increasing population and increasing demands on the provision of public services these negative consequences are amplified.
- There are a number of important possible consequences of public sector staff cuts: (a) Direct impacts on frontline workers; (b) Loss of highly productive workers and corporate memory; (c) Demoralisation of the remaining workforce resulting in reduced efficiency; and (c) Impact on services.

(a) Impact on frontline staff

- While governments claim that reducing back office staff will have a minimal impact on the ability of frontline workers to deliver high quality services to the public, this outcome is not assured. First, there is not necessarily a clear demarcation between the functions performed by frontline service delivery staff and their back office counterparts.
- Even where clearly defined separate roles exist, there is a distinct possibility that some of the functions performed by the back office workers are crucial for frontline workers to delivery services. As a result, reductions in the number of support workers may result in a transfer of administrative functions to frontline workers, diverting them from service delivery. These types of outcomes are counterproductive and impact adversely frontline workers and the quality and quantity of services delivered to the public.
- The fact that the majority of public sector workers are already engaged in direct service delivery and the past practice of cutting administrative positions means that it will become progressively more difficult to cut these jobs without causing major disruptions to services. As the proportion of support workers shrinks there is a danger that staffing levels will fall below a critical mass that is essential for services to be delivered efficiently and effectively. Staff taking unrostered leave would also exacerbate such situations.

- Despite assurances by governments that staff cuts will be concentrated in non-frontline areas, there are losses in service delivery positions that impact directly on the community. This is a particular problem when blanket decisions are made such as staff freezes or allowing fixed-term contracts to lapse.

(b) Loss of productive workers and corporate memory

- Voluntary redundancy avoids the acrimony experienced with involuntary redundancy but increases the risk that the most productive and experienced workers may leave the organisation. There is a danger that a large proportion of workers made redundant are among the most productive and experienced. This is because individuals faced with the prospect of voluntary redundancy assess the benefits of redundancy by weighing up the financial gains of the redundancy package against potential losses from unemployment.
- The most productive workers are more likely to secure employment quickly and therefore reap greater financial gains from accepting the package. Those with the best prospects of securing employment elsewhere are more likely to accept the package while those with few employment prospects are likely to seek redeployment because the long-term cost outweighs the short-term benefit of accepting the offer.
- Another counter-productive result of skill reduction is if the most productive workers accept voluntary redundancy or early retirement. The danger for the organisation is that losing the most productive workers will impact negatively on productivity and that the less experienced workers who remain require additional training and may struggle to cope with the extra workload.
- There is an extensive body of evidence available that find these negative impacts have occurred in a number of organisations when efficiency dividends, staffing caps and voluntary redundancies are offered.
- Further, there is undisputable evidence that shows that there are major losses of institutional memory due to downsizing, which reduces rather than enhances the efficiency of organisations.
- Negative consequences of downsizing included loss of institutional memory, service shortfalls, skill imbalances, increased use of overtime, increase in work backlogs, lowered morale and the productivity of the remaining workforce. Some organisations estimated that it may take several years to return to the previous skill levels and some had found it necessary to reemploy some of the downsized employees, either directly or on a contract basis.

(c) Demoralisation and reduced efficiency

- While organisations downsize to improve efficiency and productivity these outcomes are not guaranteed. The negative impacts on efficiency in downsized organisations are highlighted in a number of studies, which describe the effects of work intensification as work that was previously done by specialist staff (such as administrative staff) is redistributed.
- Further, in a time where the role of management becomes more critical to manage the process of change, many managers are unable to handle the increased complexity of their role and consequently suffer increased stress and psychological problems.
- Absenteeism is frequently viewed as a proxy for worker dissatisfaction. A study of absenteeism in a major public sector transport organisation in Australia during a period of modernisation and downsizing found that absenteeism increased amongst employees who intended leaving the organisation.

5.7 The wider implications of reductions in public sector staffing

- Cook, Quirk and Mitchell (2012) provide a detailed analysis of the broader implications of public sector retrenchment for Australian society.
- They highlight the loss of a national skills formation capacity leading to skills shortages, the loss of yardsticks to set decent standards of employment (the leadership role played by the public sector in areas such as non-discrimination, appointment on merit, family friendly conditions, employment security, staff training and development); and the loss of the positive aspects of public bureaucracy (equality of treatment and transparency).

5.7 Conclusion on staffing strategies

- Government policies over the past two decades have impacted significantly on public sector employment. In addition to the preoccupation with reducing debt and producing budget surpluses, governments at both the federal and state level have pursued privatisation and outsourcing and attacked employment conditions of public sector workers.
- Specific policies pursued by governments in Australia have included large rounds of staff cuts in some states, the imposition of staff ceilings, efficiency dividends, attempts to impose freeze wages or to take back long-standing payments and employment conditions.
- There are a number of trends that can be identified in the trajectory of state public sector staffing in Australia over the past few decades:
  - Increases in frontline staffing have occurred in response to increased need due to population growth, ageing of the population, the inability of people to satisfy their needs through market activity, growing social problems such as substance abuse, the impact of changes in policies relating to mental illness. There has also been recognition of new areas of need and improved methods of meeting needs identified through research.
  - Expenditure cuts in the form of ongoing efficiency dividends and cuts to specific programs have reduced public sector staffing. The evidence suggests that arbitrary efficiency dividends have long since harvested available efficiency gains so that further cuts are reflected in increased stress for remaining staff attempting to provide high quality services in a constrained environment and this has a detrimental impact on both the quantity and quality of public services. There have been notable instances, such as shared services reforms, where staffing cuts have occurred on the assumption that savings would be achieved but savings have fallen short of expectations, placing an increased burden on staff.
  - Staffing cuts or restrictions due to government imposed budget constraints or privatisation of functions:
    a) Mass redundancy exercises have a number of significant negative consequences for staff and service delivery. In the first instance there is a high level of stress for staff that results in a reduction in productive work while the redundancies proceed. The lost of productive workers reduces the overall skill level of the organisation and there is a loss of corporate memory. Some impacts on service delivery include: a decline in the quantity or range of services offered; increased waiting times; increased targeting of services so that many people miss out on services.
    b) In the case of cuts to programs, at best, this results in the loss of services that were previously provided to clients. It may also result in exacerbating the problem or causing new problems, which increase costs in the longer-term.

c) FTE ceilings and staffing freezes introduce inefficiencies, as agencies are not able to fill important positions. Attempts to circumvent FTE ceilings can result in higher costs, for example, the use of labour hire to obtain workers who are not counted in staffing figures is more expensive than direct employment of staff.

- Developments in public sector staffing throughout Australia have been dominated by State Government adherence to neo-liberal policies that have included: (1) erosion of welfare state funding through the reduction of taxation on businesses and high income earners; (2) the imposition of budget constraints on expenditure on public services; and (3) the transfer of service delivery to the private sector through privatisation, PPPs and outsourcing. Compared to their public sector counterparts, private sector workers frequently have lower levels of qualifications and endure inferior wages and working conditions. In effect these workers can be viewed as effectively subsidising the low cost production of services. Moreover, these developments have contributed to the deterioration in skill formation exacerbating skill shortages in the labour market.

6. Demographics

6.1 Overview

- Over the last two decades, Western Australian demography has echoed the national trend although the state has the third youngest oldest population (in median age terms) behind the Territories. The trends in Western Australia and Queensland appear to be similar, which is no surprise considering the net migration into these states from elsewhere in Australia.
- Western Australia, Queensland and the NT also have a higher proportion of citizens in the 1-15 year old cohort and below the national average proportions in the aged 85 years and over group. In terms of population growth, the national rate (as at December 2011) was 1.4 per cent per annum. South Australia had the second lowest population growth rate (0.7 per cent per annum) behind Tasmania (0.4 per cent per annum).
- The population dynamics have implications for the political choices the government will have to make in terms of service provision.

6.2 Dependency Ratio

- The dependency ratio is a key concept in the ageing population debate. The estimates suggest that Western Australia will move broadly in line with the national trend notwithstanding the slightly younger population in the state.
- There are three broad ways a government can address the challenges faced by rising dependency ratios:
  - Lower the sustained rate of unemployment and aim to have all willing workers engaged in productive employment.
  - Increase the productivity of workers through better public education; more integrated training programs (within a paid-work context); better investment in public infrastructure and investing in public health to improve standards.
  - Ensuring workers are productive for longer – relaxing restrictions on retirement.
- The greatest gains come from a mix of these strategies but maintaining full employment is essential and should not be sacrificed in the pursuit of higher productivity.
- At the federal level, the rising dependency ratio presents a political problem. The popular perception, promoted by some economists is that a rising dependency ratio is important because there will be a reduced tax base and hence increasing demands on the fiscal position. The fact is that it is not a financial crisis that beckons for the Federal government but a real one. Are we really saying that there will not be enough real

resources available to provide aged-care or first-class hospitals at an increasing level? As long as these real resources are available then the federal government (as the currency issuer) will be able to provide them. The problem it faces is achieving a political mandate to do so when there will be competing claims – from younger generations – on the resources.

- The problem is different at the State level given that governments are constrained both by the revenue and borrowing they can sustain and the available real resources. The goal of the state government should be to provide an adequate scope and quality of public services, which by their very nature require a motivated and well-trained staff.
- Cutting the quality, scope and volume of services in a bid to save money is a myopic, self-defeating strategy. Productivity growth will be the key to balancing the resource demands and unbridled cost cutting approaches to efficiency rarely are effective.

7. The adequacy of public services

- Cook, Quirk and Mitchell (2012) traced the development of state government policies in Australia over the past few decades. They demonstrated that governments have predominantly pursued policies that fit within the rubric of neo-liberal policies that privilege a concept of "fiscal responsibility", which involves providing funding and staffing resources for core services and withdrawing from non-core areas, and a shift from "rowing to steering" through the transfer of functions to the private sector through privatisation, PPPs and outsourcing.
- Cook, Quirk and Mitchell (2012) concluded that there is a recurring pattern of inadequate provision due to public sector retrenchment and fiscal austerity is discernible across a wide spectrum of service areas. They conducted three in-depth case studies encompassing: (a) the state of child protection; (b) social housing and (c) biosecurity/primary industries research – each of which revealed a failure to invest in our nation's future, a failure of governance and the abandonment of equity as a core policy principle.
- The case study concerning biosecurity and primary industries research focused on Western Australia and revealed disturbing consequences of public sector funding and employment cuts. The recent developments relating to the Barnett Government, which were reported in that case study are reproduced in Appendix A of this Report.
- Cook, Quirk and Mitchell (2012) noted the paucity of information governments provide as to the quantity and quality of service provision. In general there is a reliance on data collected by the government agencies themselves who, in turn, report on their own performance. This becomes problematic.
- Cook, Quirk and Mitchell (2012) also observed that while governments are aware of the suffering and neglect of the most vulnerable and disadvantaged Australians, be it due to their geographic location, the socio-economic status of their parents, or crises they have encountered in their lives, their race, disabilities that they were born with or have acquired, governments have applied insufficient resources to their care and inclusion.
- After 35 years of public sector retrenchment we see little evidence that the supposed efficiencies, cuts to services, have freed resources in order that they be invested where they are most needed, as has been repeatedly claimed as the justification. We see cuts to services that needed more resources, and falling levels of public provision in so many areas, while wealth has accrued to the wealthiest, most politically powerful sectors of society.
- We have underutilised our human and other productive resources across the country for decades, denying training and employment to hundreds of thousands of people who were

available to provide these services, under the spurious assertion that it is efficient to do so, and left a trail of suffering and unrealised potential in our wake as a consequence.

1. Introduction

The Western Australian Government recently released an updated budget outlook in the form of its "Pre-election Financial Projections Statement" (Department of Treasury, 2013), which took into account the improvement in commodity prices and the slight appreciation in the Australian dollar since the mid-year review was published in December 2012.

These changes, in addition to other changes on both the expenses and revenue side of the Budget, resulted the Treasury projecting higher Net Operating Balances over the forward estimates period to 2015-16 than were anticipated in the original 2012-13 Budget exercise and in the mid-year review in December. The variances were projected gains of $101 million in 2012-12, $577 million in 2013-14 (turning a Net Operating deficit of $187 million into a surplus of $290 million), $389 million in 2014-15 and $15.4 million in 2015-16. Over the entire forward estimates period the cumulative gain in the Net Operating Balance is $1,082.6 million.

By 2015-16, the Western Australian Treasury is projecting a $1.7 billion dollar Net Operating Balance. That is, it is running a fiscal strategy that willingly intends to overtax the state relative to expenses by $1.7 billion or 0.62 per cent of projected Gross State Product. That is, by any measure an extraordinarily large net withdrawal on the recurrent budget.

It is also clear that the Government is planning to maintain a tight control on expenditure and will achieve that, in a significant way, by continuing to impose so-called efficiency dividends and staffing caps. The nomenclature is interesting. Efficiency dividends imply that there is scope (several percentage points worth of overall expenses) to achieve improved productivity gains without compromising the quality and scope of the functions in question. If those productivity gains are not achievable or come at the cost of actually reducing the service delivery capacity already in place then all the government is doing is cost cutting. There is a large and convincing literature that shows that attempting to save outlays by unproductive cost cutting and on-going intensification of work is self-defeating. We review that literature in this Report.

The efficiency dividend strategy is now several budgets old and there is already sufficient evidence to demonstrate the lack of significant improvement in service delivery as a diminishing staff complement struggle to cope with the conflicts involved with increased demand for their services and a cumulative cuts to agency budgets.

Even if there had been scope for improvement in the past – the assumption that cumulative cuts will continue to generate on-going improvements is demonstrably flawed.

In seeking a justification for running a fiscal strategy that stretches and undermines the capacity of the public sector to fulfil its basic raison d'etre – that is, to deliver high quality service to the citizens of Western Australia, we encounter three broad arguments.

First, there is an implied but unexplained prudence in achieving certain financial outcomes such as surpluses and reduced net debt independent of the size of the economy.

Second, that the Net Operating Surpluses provide a buffer for the Government, which faces volatility of a key revenue driver – the iron ore prices which generate royalties.

Third, that increasing Net Operating Surpluses allow the Government to fund an increasing proportion of its capital investment program without issuing debt.

All three of these justifications fail to satisfy reasonable assessment criteria. This Report shows that the sort of financial ratios that have become ends in their own right must be interpreted relative to the basic functions of the government. The government doesn't exist to run surpluses. It exists to provide first-class services across a broad range of areas. That will typically require it to run balanced recurrent budgets to avoid it overtaxing the current generation or spending less than is required to fulfil its basic goals.

Further, while commodity prices are volatile and royalty revenue does fluctuate, that has always been the case and there is no evidence that buffers of the size projected are an optimal way to meet this volatility. It is also the case that other revenue sources (such as GST receipts from the Commonwealth) are likely to be inversely related to the royalty income, thus attenuating the alleged revenue volatility.

Finally, the striking aspect of the Western Australian Government's fiscal strategy is that it considers it appropriate to, at least partially, but increasingly, fund the State's Asset Investment Program from operating surpluses and any departure from that situation is considered to be a source of concern.

Any strategy that seeks to fund capital investment from recurrent revenue violates basic public finance principles relating to efficiency and intergenerational equity. There is no justification in the broad economics literature on optimal budget practice that justifies such a strategy. The correct fiscal strategy is to fund all recurrent liabilities (such as interest payments on debt) from current income and spread the costs of infrastructure investment across time in proportion to the temporal distribution of benefits generated by the infrastructure. The vehicle for correctly matching intertemporal costs and benefits is public debt.

By issuing debt, the Government ensures that the current generation does not endure disproportionate costs for benefits that future generations will receive. The costs to the current generation of this strategy manifest as higher than necessary tax burdens and/or diminished scope and quality of services. Neither is warranted and both are totally avoidable if correct fiscal practice is deployed.

This Report explains why adopting a strategy where large operating surpluses are designed to fund some or all of the capital investment is not a responsible fiscal position to take and undermines the scope and quality of the services that recurrent spending can provide.

It is not only an inefficient strategy (in that it reduces spending that can improve the productive potential of the economy in the future) but it also violates basic inter-generational equity principles, which require that the costs and benefits of any infrastructure services be spread over time.

2. A framework for evaluating fiscal policy choices and outcomes

2.1 Introduction

This section introduces a conceptual framework to help us understand the budgetary process. Fiscal strategies entail setting targets for net operating balance and net debt target, along with other objectives. Adherence to neo-liberal fiscal strategy dictates that governments strive to achieve what is now referred to as fiscal sustainability, which is normally defined in terms of achieving some narrow and arbitrarily defined financial ratios – such as budget surpluses and minimising net debt.

The alternative approach, which delivered full employment for 30 or more years following the Second World War was to define fiscal sustainability in terms of the responsibility of governments to ensure that the spending gap left by non-government saving was filled with deficit spending. A sustainable fiscal position was one that supported sufficient spending growth to ensure there were jobs for all those who desired to work.

In the post-war period governments in the advanced industrial countries utilised macroeconomic policy to support economic growth and maintain high levels of employment to offset fluctuations in private sector activity. The major strategies for ensuring full employment were Keynesian fiscal and monetary policies including counter-cyclical capital works programs, and public sector employment.

Scharpf and Schmidt (2000a) noted that full employment policies in England combined expansion and contraction of public investment to compensate for fluctuations in private investment with interest rate variations to stimulate private investment (Beveridge, 1944; Cass and Freeland, 1994; Scharpf and Schmidt, 2000b). A similar policy of counter-cyclical public capital expenditure was pursued in Australia in conjunction with attempts to stimulate private investment by maintaining low interest rates and controls over bank lending (Coombs, 1994).

The redistributive pillar of the welfare state operated through fiscal policy. Governments financed transfer payments for those in need, primarily those unable to earn a living from market activities; those who were unemployed, elderly, disabled, or had family responsibilities. Increasing costs for transfers emanated from the expansion of eligibility criteria over time as governments accepted responsibility for the welfare of new groups and increases in benefit rates (Heidenheimer, Heclo and Adams, 1990).

Governments also financed the social wage aspects of the welfare state by direct provision of a range of services to satisfy the needs of citizens. Government funded services such as health, education, housing, disability and community services expanded rapidly in the decades to the mid 1970s. These services were outside the ambit of the market so that the profit making opportunities of the private sector were reduced.

Education expenditure increased rapidly from the early 1960s to the mid 1970, rising from 3.2 per cent of GDP in the OECD-18 countries to 4.9 per cent (OECD, 1978). Similarly, the public share of health expenditure in these countries increased from 60 per cent in 1960 to 75.4 per cent in 1975. In Australia public expenditure on education increased from 2.4 per cent of GDP to 3.8 per cent of GDP over this time, while the public share of health expenditure increased from just over half to almost three-quarters (OECD, 1978).

The third aspect of fiscal policy involved taxation measures. Progressive income taxes ensured that high-income earners made a greater proportional contribution to fund collective provision. Tax increased from around 25 to 33 per cent of GDP in the mid 1950s to between 35 and 50 per cent by the mid 1980s (Heidenheimer, Heclo and Adams, 1990). High levels of economic growth facilitated full employment, simultaneously providing taxation revenue for delivery of formal welfare programs, and reducing need for social services (Stilwell, 2000).

In the 1980s, the objective of neo-liberal policies was to reduce deductions from surplus value that constituted the provision of services or the social wage, to return functions to the market to open up new profit making opportunities and to shift the financial burden for collective provision from governments to individuals through changes in the tax burden, targeting of services and increased co-payments for some services.

The ascendency of neo-liberal policies after the economic crisis of the mid-1970s was predicated on the alleged failure of Keynesian policies. The emergence of stagflation, a situation where high unemployment rates coexisted with high inflation rates, challenged the conventional wisdom that there was an unemployment-inflation trade-off. Governments abandoned the pursuit of full employment in favour of attempting to fight inflation first. Fiscal consolidation was proposed as a means of stimulating economic activity through generating higher levels of private sector investment (Cook et al., 2008). However, Mitchell and Muysken (2008) point out that the neo-liberal logic is flawed since government surpluses equal non-government sector deficits, resulting in a slowing of economic activity.

The past three decades have witnessed fundamental changes in the conduct of fiscal policy. Reversing the trend up to the mid 1970s, governments have sought to reduce real income support benefit levels and eligibility criteria has been tightened to minimise expenditure. Spending on direct service provision has failed to expand in line with need. Moreover, the funding burden has shifted to low- and middle-income earners through increased reliance on indirect taxes such as the GST and significant reductions in company and income taxes, particularly for high-income earners.

The magnitude of the task of reversing welfare state provision has required a sophisticated campaign so that governments can successfully implement profoundly unpopular cuts to community benefits while minimising the political backlash. In terms of taxation, governments have progressively reduced the burden on companies through reductions in company tax rates and other imposts such as payroll tax. These policies have been justified as necessary to maintain international competitiveness and on the basis that mobile capital resources would leave Australia for lower taxing locations. State governments have also engaged in bidding wars to attract inward investment by providing tax breaks or discounts for services such as electricity (Cook, et al., 2008).

In Australia, Commonwealth and state governments embarked on fiscal consolidation from the 1980s (Wilkinson, 2010; Greun and Sayegh, 2005). In order to overcome popular opposition to reductions in public services, or the failure to expand services to meet need, governments have argued that the gravity of the fiscal situation is such that there is no alternative. Governments have also split consumer groups by promoting private alternatives such as private education and private health insurance, that leave the more disadvantaged reliant upon the public sector.

The ability of governments to constrain spending has been enhanced by the introduction of fiscal rules that specify various fiscal targets to ensure “fiscal sustainability”:

- Net operating balance: achieving balance or a surplus in each year or over a period of time; or achieving a surplus of a certain size which may be specified as an actual amount or a proportion of GSP;
- Use of recurrent funds to finance capital investment strategies thereby violating basic intergenerational equity;
- Net Debt: to reduce net debt by specified amounts; to maintain negative net debt; to ensure net debt remains below a proportion of GSP;
- Maintaining a particular credit rating or regaining a higher credit rating;
- Limits on total expenditure in absolute or relative terms; and
- Revenue rules that limit revenue raising or growth rates, with a view to maintaining competitiveness.

2.2 Understanding budget outcomes

An important point that is overlooked when governments attempt to narrow their fiscal capacity by imposing arbitrary rules, such as balancing the budget over the economic cycle or running continuous surpluses is that the actual budget outcome that eventuates each year (or period) is not solely determined by the discretionary fiscal stance of government. The final budget outcome is in an important way determined by a range of factors that include wider economic conditions that are beyond the immediate control of federal and state governments.

In that sense, trying to impose arbitrary fiscal rules, which limit the responsiveness of government fiscal policy to changing circumstances, is likely to be a failed strategy. The imposition of fiscal austerity in many nations at present is seeing their real sectors collapse but the financial ratios the governments are targeting move in the opposite direction to that desired.

Australian state and territory governments publish various budgetary concepts in their Budget Papers each year. The ABS *Government Finance Statistics* publication (5519.0.55.001) defines the following terms:

- The net operating balance measures, in accrual terms, the gap between recurrent expenses and revenue for a given period. This is the headline measure used by most States and provides an indication of the medium-term sustainability of the existing level of government services. The Commonwealth does not use net operating balance as a headline fiscal indicator.
- A fiscal surplus indicates that a government is saving more than enough to finance all of its investment spending and is therefore not contributing directly to the current account deficit. A fiscal deficit indicates that a government needs to borrow or liquidate financial assets in order to fund its capital and/or recurrent expenditures.
- As the fiscal balance includes capital transfers and investment in non-financial assets, which are not included in the net operating balance, the difference between the fiscal balance and the net operating balance is the effect of investment in infrastructure.
- The cash balance is the equivalent of a fiscal balance measured on a non-accrual basis, that is, capturing payments and receipts as they occur. It therefore reflects the extent to which cash is available to a government.

While governments make discretionary choices, which influence the outcome of its final budget balance – the Net Operating Balance – the reality is that the final result is tied to the state of the economy.

In terms of a state government– the Net Operating Balance - is the difference between total state revenue and total state outlays. So, if total revenue is greater than outlays, the budget is in surplus and vice versa.

Many observers and politicians use the actual reported budget balance to indicate the fiscal stance of the government. So, if the budget is in surplus they conclude that the fiscal impact of government is contractionary (withdrawing net public spending), and if the budget is in deficit, they conclude that the fiscal impact is expansionary (adding net public spending).

However, the complication is that we cannot then conclude that changes in the fiscal impact reflect discretionary policy changes. The reason for this uncertainty is that there are automatic stabilisers, which are in-built into the budget outcome and vary with the level of economic activity independent of discretionary policy changes.

To see this, a simple model of the budget balance can be written as:

Budget Balance = Revenue – Spending.

Budget Balance = (Tax Revenue + Other Revenue) – (Welfare Payments + Other Spending)

We know that Tax Revenue and Welfare Payments move inversely with respect to each other, with the latter rising when growth in State Product falls and the former rises with growth in State Product. These components of the Budget Balance are the so-called automatic stabilisers. In other words, without any discretionary policy changes, the recorded Budget Balance will vary over the course of the business cycle.

When the economy is weak, tax revenue falls and welfare payments rise and so the Budget Balance moves towards deficit (or an increasing deficit). When the economy is stronger, tax revenue rises and welfare payments fall and the Budget Balance becomes increasingly positive. Automatic stabilisers attenuate the amplitude in the business cycle by expanding the budget in a recession and contracting it in a boom.

As we will see in Section 3, there was a major cyclical decline in tax revenue available to the Western Australian government as a result of the GFC.

As a result, we cannot conclude that a rising budget deficit indicates that the State government has suddenly become of an expansionary mind. An important point to understand is that the actual budget balance is to a major extent, out of the control of the state government because the cyclical component reflects the variations in the spending decisions of private sector agents (household, business firms, external relations). As a result, it is often counter-productive for a government to attempt to cut back the budget outcome with discretionary spending cuts and/or taxation increases because it fears the budget balance is excessive.

In these circumstances, the imposition of austerity may then cause State Product to contract and the automatic stabilisers (principally, tax revenue at the State level) to push the budget further into deficit. It also follows that a growth strategy underpinned by discretionary stimulus spending and/or tax cuts can drive reductions in the budget deficit outcome as the level of economic activity increases and tax revenues recover.

To overcome this uncertainty, economists devised what was called the Full Employment Budget to benchmark the actual budget balance against. In more recent times, this concept is now called the **structural balance**, which is a hypothetical budget balance that would be realised if the economy were operating at potential capacity or full employment.

In other words, the budget position (and the underlying budget parameters) would be calibrated against some fixed point (full capacity) and thus eliminate the swings in the budget balance that arise from variations in the business cycle. These cyclical swings in activity around full employment or capacity would be separated out from the underlying budget position, which would then reflect the discretionary fiscal stance chosen by the government.

If the structural component of the budget outcome is balanced then it means, conceptually, that total outlays and total revenue would be equal if the economy was operating at total capacity. If the budget were in surplus at full capacity, then we would conclude that the discretionary fiscal stance was contractionary and vice versa if the budget was in deficit at full capacity.

We thus urge caution when dealing with discussions surrounding the dynamics of a state budget and efforts have to be taken to decompose the structural and cyclical components of the actual reported budget outcome before any analysis of the discretionary fiscal stance is engaged. It is impossible to make any sense of the appropriateness of the fiscal stance of the state government without first undertaking this decomposition.

2.3 Funding the capital budget

The net operating balance is the difference between recurrent revenue and spending. Net public investment is the sum of purchases of non-financial assets less sales of the same less depreciation plus change in inventories plus incidentals, which are typically zero.

The sum of the net operating balance and net public investment is equal to how much the government had to borrow in the given fiscal year.

One of the characteristics of the neo-liberal period has been an aversion for state governments to use debt to underpin the development of productive public and social infrastructure. In the full employment period prior to the 1980s, governments used debt to fund non-recurrent expenditure because they knew this allowed the costs and benefits of large-scale investments to be temporally matched in an efficient and fair manner.

Under the neo-liberal fiscal mentality that now dominates, state governments aim to run surpluses on the operating account of sufficient size in order to use the excess of revenue (mostly taxes) over recurrent spending to fund public infrastructure investments and/or pay down outstanding net debt.

Very little evaluation has been done on the consequences of this policy shift. As we will see in Section 3, this approach is a defining characteristic of the fiscal strategy employed by the Western Australian government.

What is wrong with this fiscal behaviour?

Quite apart from whether the structural budget outcome provides an adequate degree of expansion, the strategy employed by the Western Australian government, both undermines the scope and quality of recurrent services that can be provided and also violates reasonable rules of intergenerational equity.

Running recurrent surpluses that are greater than net public investment (and thus paying off debt) forces the current generation to pay for the benefits of a later generation in the form of higher than necessary taxes or lower volume and/or quality of services.

Economists adopt what is called the "golden rule" when it comes to financially constrained governments and their capital expenditure. The Western Australian government is financially constrained because it does not issue its own currency. In that sense, unlike the federal government, state governments have to fund their spending with a mix of taxation and bond issuance.

The golden rule relates to the observation that sound fiscal practice requires the government to match the burden of the costs of public infrastructure provision with the temporal profile of the benefits that the infrastructure delivers. Long-lived capital delivers benefits to future generations. It is considered only equitable if the costs incurred in providing those benefits are correctly matched.

Equity is achieved by targeting balanced recurrent budgets net of capital spending, but recognising the need for and inevitability of recurrent deficits when non-government spending is weak and employment growth is declining. In that context, there will sometimes be a need to use borrowing to fund recurrent services and other operating expenses. That is a sound strategy if it is pursued in a counter-cyclical manner.

In addition, the achievement of equity also requires that capital expenditure should not be funded from current taxation as a means to avoid borrowing. State governments have fallen prey to the spurious argument that if they resist borrowing they will ensure the rating agencies reward them with AAA ratings. However, this is an irrational strategy because the only purpose of a AAA rating is to reduce the cost of borrowing. In that context, borrowing should fund capital expenditure and the servicing costs then prorated over the life of the asset by a claim on recurrent revenue.

The Western Australian government's fiscal strategy appears to be inconsistent in this regard. It seeks expanding Net Operating Surpluses to fund an increasing proportion of its capital works program, which violated the fundamental Golden Rule principle of public finance. This violation not only imposed unfair burdens on the current generation but their fiscal conservatism has also seen a reduction in the rate of capital infrastructure development, a problem they are now having to face as essential capital works are necessary.

An AAP media report (Sydney Morning Herald, February 18, 2012 - "Barnett's 'pants pulled down' by Moody's") - exemplified the confusion about this issue in state politics at present.

The ratings agency Moody's has placed the Western Australian government on a "negative" watch because it proposes to use debt to fund large scale capital projects such as the new light rail project and the airport rail line.

The current Premier was reported as saying:

> There will be growth in state debt ... To build major capital projects it is sensible that you finance them through borrowings. A generation cannot pay for major projects in one year ... They will be funded through budget surpluses and through borrowings - we always keep a tight rein on infrastructure.

That position exemplifies sound fiscal practice although as we will see the current Western Australian government is not consistent in its application of the Golden Rule principle as is compromising service scope and quality by attempting to pay for significant components of the capital investment from Net Operating Surpluses.

The irony is that the Opposition Shadow Treasurer responded to the Premier's statement by claiming that if it wins the election the Labor government would "find $4 billion in savings to pay for its Metronet rail scheme" (that is, fund the capital budget from recurrent revenue) and he also claimed that the current government "would leave future generations in trouble".

He also told the press that the Western Australian government could no longer borrow because it had "maxed out the credit card" and indicated that Moody's assessment "highlighted that Colin Barnett's economic management has been abysmal".

The Opposition's claims highlight the quandary that it now faces. Its view is contrary to basic principles of public finance which attempt to establish intergenerational equity while still provide the essential public infrastructure that underpins and supports social and economic development.

The Western Australian government has not exhausted its borrowing capacity. The thirst for sovereign debt in a climate of increasing risk is very high and will continue so for decades to come. The new prudential requirements that the Bank of International Settlements have defined and which the Reserve Bank of Australia has supported as a reasonable operating environment for our commercial banks to work within also ensure that the demand for zero risk (Australian government debt) or extremely low risk (State government debt) will remain strong for years to come.

Further, the tax base of the Western Australian government is robust and will expand with the growth in the economy. There is no sense that it is imposing unfair or unaffordable burdens on the future generations.

In fact, its ambitious public infrastructure investment program will improve the fortunes of the future generations and open up more options to them. If the Government adopted the Opposition's plan to fund all capital works out of recurrent revenue by savings - which means cuts in other recurrent programs - then it would be unreasonably punishing the current generation and in all probability undermining the future potential of the economy and the next generations (by starving current services).

Further, the ratings agencies should not be used as benchmark for defining fiscal prudence. They lost all credibility in the lead-up to the GFC by fraudulently providing the highest ratings to assets they knew were of inferior quality and were at a high risk of failing.

They also have a history of rating sovereign states as high risks when it is clear that the sovereign issues its own currency and is never at risk of default. Classic cases include the downgrading of Japan several times in the last 15 years and the recent downgrading of the US government debt. In both cases, the yields on the sovereign debt fell and remained at low levels because bond markets realise that the views of the ratings agencies are largely irrelevant to those attempting to correctly assess sovereign debt risk.

It is clear in the case of Western Australia that Moody's is seeking, like the Labor Party, to violate the Golden Rule of public finance - that the costs and benefits of government service and infrastructure spending be correctly matched over time.

We will return to the specific analysis of the Western Australian state budget in Section 3 and apply the principles developed in this section to form our assessment of the validity of the fiscal strategy being deployed by the current government.

2.4 Commonwealth-State financial relations in Australia

In Australia, the responsibility for the delivery of public services is influenced by the institutional arrangements that flow from the Australian federal system. All three levels of government assume responsibility for service provision. In contrast to local authorities in other countries, Australian local governments are responsible for a smaller range of services that have traditionally centred on development of physical infrastructure and waste services. However, in recent years local government has expanded its role to include a broader range of community services (Worthington and Dollery, 2000).

Traditionally State/Territory governments have provided infrastructure and social services such as: roads; railways; water; electricity; public housing; public transport; health; education; child protection; corrective services and a variety of social services. The Commonwealth is solely responsible for a range of social services and welfare payments.

Vertical fiscal imbalance, whereby the Commonwealth Government has primary responsibility for raising taxes while State governments shoulder responsibility for delivery of major social programs, has affected the provision of services such as health and education. Vertical fiscal imbalance means that federal or joint federal / State financing is essential to service provision and there is a long history of disputation regarding the adequacy of funding and blame-shifting in relation to political responsibility for failures in service delivery.

The Council of Australian Governments (COAG) provides a framework for inter-governmental policy development. Australian Governments signed the *Intergovernmental Agreement on Federal Financial Relations* (IGA) in December 2008. This agreement reformed Commonwealth/ State financial relations to embed a greater emphasis on shared outcomes and improving service delivery as well as improving accountability and streamlining funding arrangements.

The Australian Government provides two major types of funding to states: General Purpose Payments (GPPs) and Specific Purpose Payments (SPPs). SPPs include (Australian Budget 2011-12):

- National SPPs for key services: National Healthcare SPP; National Schools SPP; National Skills and Workforce development SPP; National Disability Services SPP; and National Affordable Housing SPP;
- National Health Reform (replacing the National Healthcare SPP on 1 July 2012); and
- National Partnership payments (NPPs) for States to deliver specific projects that could include improving the quantity or quality of service or to reward States for implementing significant reforms or improving service delivery.

A process of horizontal fiscal equalisation is implemented by the Commonwealth Grants Commission to allocate funding to the states on the principle that each state and territory should have the financial capacity to provide the same level of service to citizens, subject to comparable revenue raising efforts and operational efficiency in service delivery (Pickernell, et al., 2008).

A report on the review of GST revenues was delivered in October 2012 and it was acknowledged that the claims by the Western Australian government to keep a higher proportion of the GST the state raised was rejected by the panel. It was noted that the diminishing share of total GST revenue enjoyed by Western Australia was a function of the strength of mining royalties (GST Distribution Review, 2012)

Table 1 details Commonwealth payments to the States between 2011-12 and 2015-16. Over the period there will be an overall increase of only 2.2 per cent per annum. There is a differential rate of growth of funding, with GPPs increasing by 5.6 per cent per annum, while SPPs will contract at 1.6 per cent per annum. The decline in SPPs is largely due to the winding back of the stimulus spending. Victoria will receive a 0.6 per cent increase it in its share while Queensland's share of funding will increase by 1.1 per cent. The ACT also enjoys a 0.2 per cent increase in its share.

All other states and territories will record a decline in their share of funding, with Western Australia having to endure the largest fall (2.3 per cent). New South Wales loses 0.5 per cent share, South Australia 0.4 per cent and the Northern Territory's share will fall by 0.5 per cent.

Table 1 Commonwealth payments to the States, 2011-12 to 2015-16

	NSW $m	VIC $m	QLD $m	WA $m	SA $m	TAS $m	ACT $m	NT $m	Total (a) $m
2011-12									
Payments for specific purposes	15,117	11,081	10,796	5,028	4,222	1,202	709	1,253	49,442
General revenue assistance	14,155	10,298	8,601	3,495	4,239	1,643	861	2,494	46,714
Total payments to the states	29,272	21,380	19,396	8,523	8,461	2,845	1,570	3,747	96,156
2012-13									
Payments for specific purposes	12,551	9,872	8,394	4,526	3,136	977	598	894	40,989
General revenue assistance	14,845	11,097	9,667	2,873	4,512	1,704	975	2,714	49,381
Total payments to the states	27,396	20,970	18,060	7,399	7,648	2,682	1,573	3,608	90,370
2013-14									
Payments for specific purposes	13,355	11,136	9,029	4,968	2,993	974	687	670	44,379
General revenue assistance	15,866	11,401	11,194	2,173	4,782	1,720	1,027	2,912	52,039
Total payments to the states	29,221	22,537	20,224	7,141	7,776	2,694	1,714	3,582	96,418
2014-15									
Payments for specific purposes	13,178	10,837	8,801	4,659	3,004	954	767	612	44,187
General revenue assistance	16,730	11,836	12,274	1,731	5,104	1,771	1,108	3,123	54,632
Total payments to the states	29,908	22,674	21,075	6,390	8,108	2,725	1,875	3,734	98,819
2015-16									
Payments for specific purposes	13,834	11,365	9,376	4,898	3,453	1,059	779	659	47,273
General revenue assistance	17,502	12,460	12,872	1,913	5,306	1,832	1,159	3,214	57,214
Total payments to the states	31,337	23,825	22,248	6,811	8,759	2,891	1,938	3,873	104,487

Note: (a) total column may not equal sum of State totals. There is no basis on which to estimate State allocations for a number of payments which are not reflected in State totals.

Source: Australian Government (2011) Budget Paper 3, 2012-13 Budget

Federal Government policies may assist or hinder State Government attempts to deliver specific Budget outcomes. For example, the large funding injections from the economic stimulus packages following the onset of the GFC supported economic activity throughout Australia to modify the contractionary effects of the reduction in private sector activity.

As a consequence, State government finances that are sensitive to the level of economic activity, such as payroll tax and stamp duty, declined less than would have otherwise been the case. By supporting employment in infrastructure projects, Commonwealth funding also assisted to reduce the demand for welfare services provided by the States. In contrast, the obsessive pursuit of a budget surplus in 2012-13 by the Gillard Labor Government has resulted in significant cuts to Commonwealth spending that have clearly contributed negatively to real GDP growth.

In the last September-quarter 2012 National Accounts release, the contribution of government to growth was negative (-0.5 per cent) and exactly offset the positive contribution from private capital formation. The withdrawal of federal government fiscal support is a principle reason the Australian economy is now slowing and currently growing well below trend. It is also the principle reason state revenues are still struggling to recover from the downturn.

3. Fiscal strategy and outcomes: Western Australia

3.1 Background to current fiscal strategy in Western Australia

The current fiscal strategy was set in train after the 1991 recession by the Lawrence ALP government. In 1992, they defined a strategy for Western Australia which emphasised: containing increases in total state debt to at least 1 per cent less than economic growth (on average); repayment of debt; and, regaining the Triple-A credit rating in the medium term (Wilkinson, 2010).

The incoming Court Liberal-National Government (1993-2001) continued to prioritise debt reduction and surplus budgets. The *Government Financial Responsibility Act 2000* established principles that included: funding current services from current revenues; spending and taxing policies that ensured stability and predictability; and prudent management of financial risks (Government of Western Australia, 1999 Budget Paper 3).

The fiscal policy developed is shown in Table 2. Targets included net assets, net debt, operating expenses, the operating balance, and rationalisation of public sector ownership.

Table 2 Fiscal strategy, Court Government

Item	**Target**
Net assets	Maintained or increased
Net debt	A declining net interest cost as a proportion of own source revenue for the public sector
Operating expenses	Real per capita expenses for the Consolidated Fund Entity be decreased
Operating balance	An accrual operating surplus for the total public sector
Cash surplus	The Consolidated Fund and general government sectors run an underlying cash surplus
Risk management	Maintenance over the forward estimates of the financial management plan announced in the 1998-99 Budget to manage and fund accruing superannuation liabilities
Public ownership	Rationalise ownership of assets exposed to business risks

Source: Government of Western Australia, 1999

During the term of the Court Government, a privatisation program was implemented that resulted in the sale of the State Government Insurance Office, BankWest and the Western Australian State Printing Division.

The Labor Governments of Gallop (2001-2006) and Alan Carpenter (2006-2008) maintained this fiscal stance and sought to achieve net operating surpluses and reduce debt (Wilkinson, 2010).

The Government undertook to implement election promises through savings, such as, a reduction in the number of ministers; cuts to spending on advertising and consultants, the introduction of a 'priority dividend' that grew from 1.5 per cent of agencies' total operating expenses in 2001-12, to 2 per cent in subsequent years and then a further $50 million per annum (Government of Western Australia, 2001 Budget Paper 3).

Frontline services including health, education, police, community development and the Disability Services Commission were exempt from the priority dividend. The fiscal strategy outlined for the 2001-02 to 2005-06 period were (Government of Western Australia, 2001 Budget Paper 3):

- Introduction of the Government's election commitments in a fully funded manner;
- Achievement of the Government's election platform within a framework of fiscal targets:
    - Retain the State's triple-A credit rating;
        - Net debt to total non-financial public sector revenue at or below 45 per cent; and
        - Real per capital expenses for general government not to increase.
    - Maintain or increase the net worth of the public sector;
    - Achieve an operating surplus for the general government sector; and
    - Maintain Western Australia's tax competitiveness.
- Repair of a growing imbalance between revenue and expenses which resulted in four consecutive operating deficits to 1999-2000, and was masked in 2000-01 by unusually strong growth in revenue parameters and one-off factors including asset sales; and
- The implementation of revenue measures which contribute to the equity and efficiency of the tax system to address the imbalance.

In the 2001-02 Budget, the government announced an enhanced voluntary redundancy package for public sector employees and a process of functional reviews to be conducted in 2002-03 to identify areas of duplication or functions that 'least serve priority community outcomes' (Government of Western Australia, 2002: 8 Budget Paper 3) with a view to redirecting resources.

Continued targeting of expenditure is reflected in the increase in spending on health, education and training, law and order and community support of $352 million (or 84 per cent of the total increase in general government expenses in 2004-05). Reductions in state government charges for stamp duty on property conveyances, land tax and household fees and charges were also provided.

The fiscal targets presented in the 2005-06 Budget further defined specific objectives and measures:

- Maintain or increase the net worth of the public sector;
- Achieve an operating surplus for the general government sector;
- Retain the state's triple-A rating

    - Maintain the debt to revenue ratio for the non-financial public sector at or below 14 per cent; and
    - Ensure that real per capita own-purpose expenses for the general government sector do not increase;
- Maintain Western Australia's tax competitiveness – maintain tax revenue as a share of GSP below the other states' average.

Throughout the term of the Labor Governments, surpluses were used to fund capital investments thus violating the Golden Rule of public finance. New spending initiatives and tax relief were also provided. In 2007-08, the government announced housing affordability and climate change measures as well as the establishment of the Department for Child Protection in response to the Ford Review Report. In the 2008-09 Budget the government announced the building of the Fiona Stanley Hospital through a public private partnership that would not increase public sector debt, and other infrastructure programs.

The current Barnett Liberal Government took office in 2008 as a minority government supported by the National Party. It cited the declining economic situation at the time associated with the Global Financial Crisis as the motivation for a 3 per cent efficiency dividend and caps on public sector staffing in the 2009-10 Budget along with other savings measures while maintaining the long-standing fiscal strategy and targets with some amendments:

- Maintain or increase the real net worth of the total public sector;
- Achieve an operating surplus for the general government sector;
- Maintain the ratio of total non-financial public sector net interest costs as a share of revenue at or below 5 per cent;
- Ensure that real per-capita own-purpose general government expenses do not increase; and
- Provide a fair and efficient taxation system that is competitive with other Australian States.

The new targets replaced the former net debt to revenue ratio target with a net debt affordability ratio (as measured by net interest costs as a share of revenue). The general government expense target is now based on growth in wages.

The 2010-11 Budget prioritised improvements in service delivery for key public services, infrastructure projects and the maintenance of surplus budgets allegedly to retain the Triple-A credit rating. The fiscal targets from previous years remained, except public sector interest costs were to be at or below 4.5 per cent of revenue (down from 5 per cent).

The Government outlined the policies that had been introduced to reduce the rate of growth of expenses: a 3 per cent efficiency dividend; a new policy for public sector wages; a ceiling on staff numbers; and voluntary redundancy programs (469 packages from $48 million allocated in March 2009; around 300 in March 2010; and a further 400 announced in the 2011-12 Budget). Expenditure cuts were imposed despite the fact that the Government acknowledged that the demand for services such as health and education was increasing (Government of Western Australia, 2011 Budget Paper 3 2011-12).

3.2 Recent developments in Western Australia

Buoyant economic conditions in Western Australia due to the mining boom have spared the state from some of the fiscal problems encountered by other states in recent years. Western Australia has also experienced strong population growth that has stimulated the demand for public services.

Growth in expenditure in staffing has been concentrated in frontline positions such as child protection, police and corrections staff, teachers and health professionals. However, significant expenditure and staffing cuts have also been a feature of Western Australian budgets.

The incoming Barnett Liberal /Coalition Government established an Economic Audit Committee to examine the performance of the public sector. The 2008-09 Mid Year Projections Statement (Government of Western Australia, 2008: 3) included a 3 per cent efficiency dividend that was allocated to all agencies from January 2009, which was 'integral to maintaining the State's financial health'. This measure was expected to deliver savings of $1.7 billion from 2009-10 to 2012-13 (Budget 2010-11). The efficiency dividend was subsequently extended to include a 5 per cent measure for Government Trading Enterprises from 2011-12.

In the 2009-10 Budget the Government announced savings of $1.1 billion and foreshadowed further cuts after the final Economic Audit Committee report was released. In addition to the efficiency dividend, a ceiling on full-time equivalent staffing levels was imposed in general government agencies (Government of Western Australia, 2009). Further expenditure cuts were announced in the 2009-10 Government Mid-Year Financial Projections Statement to achieve total savings of $1.4 billion in 2009-10, and $8.5 billion over the four years to 2012-13. Further savings of $300 million announced in the 2011-12 Budget are to be achieved by reviewing existing programs.

Large budget surpluses have enabled the Government to repay debt and fund some large infrastructure projects without recourse to debt financing. The Government used the surplus from 2005-06 to pay off all debt for the New MetroRail project. Similarly, $1.09 billion of the 2006-007 surplus was used to fully fund the new Fiona Stanley Hospital in Perth.

The large size of the infrastructure program meant that some debt financing was also required. In 2007-08 the Government announced that infrastructure expenditure would reach $21.6 billion over four years. The following year projected infrastructure expenditure rose to $26 billion over four years for hospitals, prisons, police stations etc. In 2009-10 the coalition Government committed to further electricity generating capacity and flagged an intention to increase the use of PPPs to deliver infrastructure. PPPs for the Queen Elisabeth II Medical Car Park, Midland Health Campus and the Eastern goldfields Regional Prison were announced in the 2011-12 Budget. The Country High Schools Hostels Authority also used PPPs to deliver residential colleges at high schools.

The Government has also outsourced a variety of services. Health promotion programs were outsourced to NGOs including healthy eating, diabetes awareness, anti-smoking campaigns and safety in the home (2007-08 Budget). Management of Acacia Prison was outsourced to SERCO in 2006. The value of child protection services outsourced to

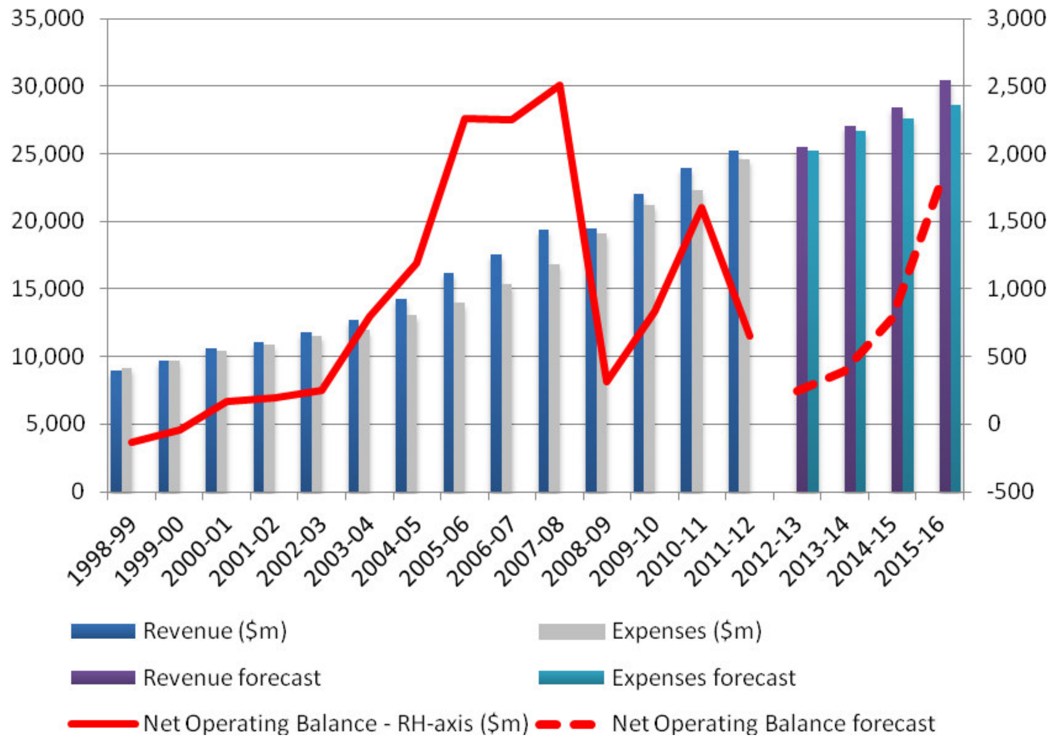
NGOs increased from $65.1 million in 2005-06 to $82.8 million in 2010-11 and continues to rise. Similarly grants to NGOs for disability services increased from $163.6 million in 2005-06 to $255.3 million in 2010-11. The value of per capita grants to private schools increased from $197.5 million to $316.8 million over the same period. Court security and custodial services and traffic infringement processing has also been outsourced.

The philosophical commitment of the current Government to outsourcing suggests that the recent acceleration will continue into the future.

3.3 Current fiscal outcomes for Western Australia

In contrast to other states, revenue growth outstripped growth in expenses in Western Australia in the period from 1998-99 to 2011-12. Figure 1 shows general government revenues, expenses and the Net Operating Balance from 1998-99 to 2011-12 and projections to 2015-16 (as outlined in the Pre-election Financial Projections Statement, February 2013). Revenue growth averaged 8.4 per cent per annum while expenses increased at 8.0 per cent.

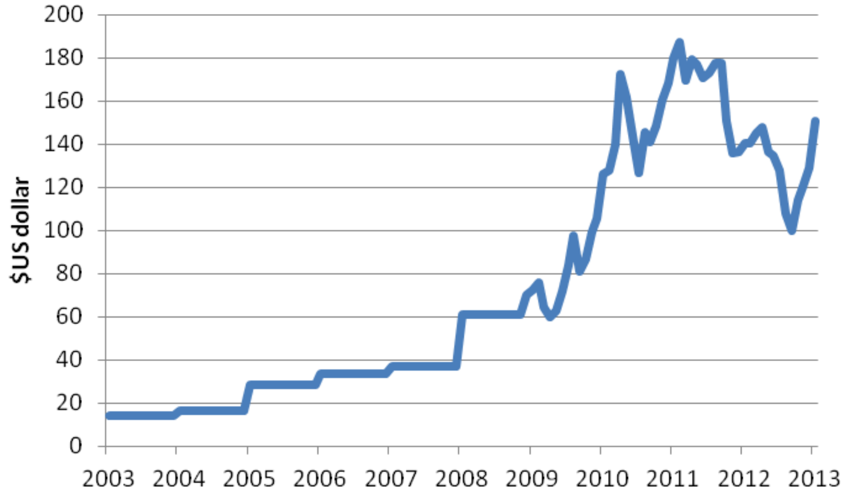
Figure 1 Revenue, Expenses and Net Operating Balance, Western Australia, 1998-99 to 2015-16



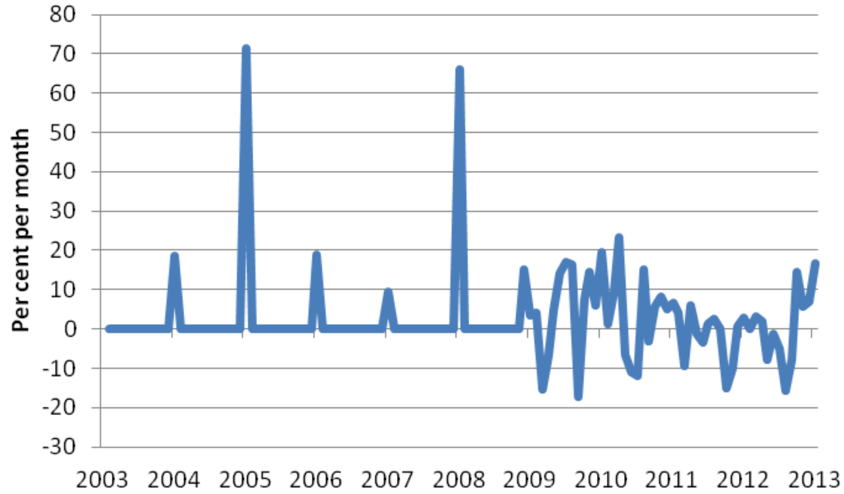
Source: Government of Western Australian, Budget papers various years

Western Australia has consistently recorded net operating surpluses since 2000-01, with the largest surpluses achieved in the period immediately prior to the GFC ($2,508 million in 2007-08). During this period there has been considerable volatility in the $US iron ore prices as is shown in Figure 2. In the post-GFC period surpluses fell, as expected but current forward estimates predict a strong Net Operating Balance for the period 2012-13 to 2015-16.

Figure 2 Iron Ore, US dollar spot price and monthly change (%), January 2003-2013



(a) Iron Ore - US dollar spot price



(b) Monthly percentage change in spot price

Source: The Steel Index, http://www.thesteelindex.com/

In the "Pre-election Financial Projections Statement" (Department of Treasury, 2013), which is the most up-to-date advice provided by the Western Australian Treasury (as of February 2013) we read (Page 6) that:

> Operating surpluses are projected for each year of the forward estimates period, with higher iron ore price forecasts relative to mid-year review being the key driver of the stronger outlook

However, they claim that there are risk factors, which could wipe out those surpluses. For example, the Western Australian Treasury Department (2013: 2) notes that:

> … the positive economic outlook is not filtering through to all State revenue, but is driving demand for government services and infrastructure through strong population growth …

After discussion the variability of iron ore prices, the WA Treasury say (Page 3):

> This serves to highlight the sensitivity of forward estimates to the volatility currently being experienced in iron ore prices, and the need to retain an appropriate buffer against adverse movements.

They argue that under certain assumptions, the 2013-14 general government net operating balance could shift from the current projection of a $390 million surplus to an $84 million deficit. It is also unclear whether the WA Treasury considers the volatility will be greater than it has been in the past. There is no current evidence available to support that view.

Further, it is unclear if the only variation they are making in the sensitivity analysis is in the royalty income as a result of a hypothesised change in the $US price of iron ore. For example, if royalty income dropped so markedly, what changes in Western Australia's projected GST relativity would result? The WA Treasury update discusses how the GST grants are made to states and territories and projects a declining relativity over the years to 2015-16 as a result of the projected mining royalties. However, they also note that the GST Distribution Review contains recommendations, which will increase Western Australia's GST grants over the next four years and "substantially improve Western Australia's funding share (beyond the current forward estimates period)" (Page 21).

There are also issues relating to the use of recurrent revenue to fund infrastructure investment, which we will return to later.

In terms of revenue growth, the Pre-election statement says (2013:8):

> General government revenue growth remains significantly lower than the long-run average growth rate of 8.5% recorded over the last decade.

However, the Treasury claim that it is reasonable to assume that (Page 8) "(a)cross the four year forecast period, general government revenue growth is expected to average 4.8% per annum".

First, it is questionable whether the entire last decade is a reasonable period on which to benchmark long-run revenue growth prospects. If we take the period before the boom in commodity prices occurred – for example, from 1999-2000 to 2003-04, revenue growth averaged 7.3 per cent per annum. Over the same period, growth in expenses averaged 5.6 per cent per annum.

Even over the extended period from 1999-00 to 2011-12, revenue growth averaged 8.3 per cent per annum while growth in spending averaged 8 per cent.

Second, the Department of Treasury suggest several reasons why revenue growth will average around 4.8 per cent over the forward estimates. These include (Page 8):

- The State's lower share of national GST collections in 2012-13;
- Lower tied grants from the Commonwealth (which 'brought forward' significant payments to the State into 2011-12 from 2012-13); and

- A large one-off revenue boost in 2011-12 (following the rationalisation of two boards, see 2011-12 Annual Report on State Finances).

The lower share of national GST, as explained above, is due to the strong royalty income that the Western Australian government is enjoying. The GST Distribution Review Report (2012) stated that:

> Recent significant and rapid improvement in the relative financial position of Western Australia, at the same time that Queensland, another major resource State, has experienced temporary setbacks from major natural disasters, has led to greater divergence in State fiscal capacities and, therefore, substantial change in the distribution of the GST amongst the States. While the situation could prove to be temporary and less extreme than first thought, these recent rapid and significant changes have heightened scrutiny about the HFE process and its outcomes.

Should the financial benefits from the mining boom languish and the relative financial position of Western Australia be impaired then reductions in the growth of GST grant income will be reversed.

Further, the other two factors identified above are not enduring factors.

On the expense side, the Department of Treasury (2013) assume that government spending will grow by an average 3.8 per cent over the next four years. In other words, even if we were to believe the overly pessimistic revenue forecasts to 2015-16, there is no major divergence likely to occur between expenses and revenue.

Moreover, if the efficiency dividends (which we consider more fully in Section 5) are maintained and the employment caps that have been announced remain in place the growth in spending will be further reduced, opening up a wider gap between revenue and expenses.

There is no coherent argument that can be made – in terms of maintaining prudent fiscal settings – for the on-going staffing cuts and cost cutting – given the current forward estimates. This also relates to our observation above concerning the sensitivity of the Net Operating Surplus to iron ore prices?

What exactly are these growing Net Operating Surpluses intended for?

The WA Treasury (2013: 36) provide their answer:

> To provide more of a buffer against increased revenue volatility, and to reduce the need for new borrowings to fund infrastructure investment, it is essential that larger operating surpluses are budgeted for and delivered in coming years.

It is an answer that should be rejected. First, there is confusion in the concept of a buffer. A buffer is a stock that can be drawn on at some future date. Presumably, if there were no variation in actual commodity prices from the projected prices, then the surplus would be available for infrastructure investment. If, for example, iron ore prices fell then royalties would be lower and some portion (perhaps all) of the infrastructure investment that would have been funded without debt would now require debt issuance. That appears to be a poor debt management strategy.

Second, and more importantly, why is debt issuance to be minimised and the planned growth of debt to (largely) independent of the size of the overall economy and the economic and social returns expected to flow from the expansion of public infrastructure?

One can agree, that at the state level, debt issuance to cover recurrent deficits would be a second-best option and should be avoided except in cases of an extreme cyclical downturn.

But there is **no economic case** that can be made to justify either over-taxing or under-funding recurrent service delivery agencies and imposing staffing cuts, which demonstrably undermine productivity, in order to create a surplus that can be used to fund capital infrastructure development.

It is clear that the Western Australian government has fallen prey to the errant thinking that is an efficient, long-term fiscal strategy to starve service delivery agencies of resources, thereby undermining the scope and quality of services to fund as much of its capital works budget as it can out of recurrent revenue.

As we learned in Section 2, this approach to public finance not only undermines the prosperity of current citizens who have to endure diminished services and/or higher taxes and charges, but also violates intergenerational equity principles by forcing the current generation to bear a disproportionately higher burden of the costs of infrastructure provision, which will provide benefits for several generations to come.

In the publicly-available documentation, there has never been a coherent intertemporal costs-benefit analysis presented by the Western Australian government, incorporating reasonable estimates of social costs and benefits, which shows the superiority of the current fiscal strategy relative to the more sensible economic strategy of funding capital investment from debt and balancing the recurrent budget.

In later sections of this Report we summarise the evidence about the costs arising from the loss of scope and quality of service delivery that have accompanied the obsession with minimising public debt and imposing efficiency dividends and staff cuts on service delivery agencies. These costs should be included in the Budget Papers alongside the other "risks" that the WA Treasury chooses to highlight. For example, the case study in Appendix A show that the risks associated with lapses of bio-security to an economy that still enjoys a strong contribution from its agriculture sector are high.

The fiscal rules outlined in Chapter 2 of the Pre-election Update (WA Treasury, 2013) bear no relation to the purpose of government. For example, there is no assessment of the loss of quality of services as a result of pursuing these rules. The implication is that the rules have meaning in their own right, which is the neo-liberal mantra. The GFC and its aftermath have demonstrated clearly that imposing financial rules on governments, which restrict their capacity to meet the challenges of the private business cycle lead to unnecessary reductions in standards of living. Fiscal rules formulated independently of social and economic goals (the real economy) defy the public purpose role of government.

Further, the 2012-13 Western Australian Budget continued to expound the myth that there is significant scope to fund new recurrent initiatives from so-called "savings" generated by cost cutting. The nomenclature used in place of the negative sounding "cost cutting" is "efficiency dividends".

In the 2012-13 Budget Paper No. 3 (Page 6) the Government notes

> The 2012-13 Budget accommodates a new round of savings measures to maintain sustainable public sector finances and facilitate new spending on priority areas. These include the application of efficiency dividends to both appropriation-funded general government sector agencies and Government Trading Enterprises (GTEs), a cap on Full Time Equivalent (FTE) staff growth in the general government sector in 2012-13 and 2013-14, as well as a formal limit on FTE staff growth from 2014-15, a strategic review of the Asset Investment Program and an increase in the Loan Guarantee Fee charged by the Western Australian Treasury Corporation for Government guaranteed lending to GTEs …
>
> These new measures build on the savings already achieved by the Government through the previous 3% efficiency dividend on the general government sector starting in 2008-09, the 5% efficiency dividend on the discretionary operating expenditure of GTEs in 2011-12, changes recommended as part of the 2009-10 Economic Audit and the $300 million targeted general government sector savings initiatives built into the 2011-12 Budget.

The actual details of the 2012-13 cost cutting measures are outlined on Page 8 of Budget Paper No. 3:

> … application of a 2% efficiency dividend to the general government sector in 2012-13, based on cash service appropriations, which will apply to most general government sector appropriation agencies and the Public Transport Authority, but excluding the Department of Education (which will be subject to a 1% efficiency dividend in 2012-13). The dividend will be cumulative, increasing by 1 percentage point in each of 2013-14, 2014-15 and 2015-16, and is expected to deliver total savings of around $1.9 billion over the forward estimates period …
>
> … application of a cumulative efficiency dividend to the discretionary expenditure of GTEs, commencing in 2012-13 (excluding the Housing Authority). This dividend will commence at a rate of 2.5%, increasing to 4.0% in 2013-14, 5.5% in 2014-15 and 6.0% in 2015-16. Port authorities will be subject to a 1.5% efficiency dividend in 2012-13, increasing by a further 1.5 percentage points per year until 2015-16. This measure will strengthen the profitability of the GTEs and increase the return to the community through higher dividends and tax equivalent revenue to the general government sector, in turn reducing pressure to increase net debt. The total savings generated by this measure are estimated to be $384 million over the forward estimates period, with a portion of the savings returned to the general government sector as higher tax equivalent and dividend revenue ($245 million) …

There is no justification for these "dividend" parameters other than the circular logic that a certain dollar end number was required and the percentage quantum for the dividends proposed achieved that end. The underlying assumption is that there is significant waste remaining in the public sector such that outcomes are not impaired by the loss of input.

While that is possible, Cook, Quirk and Mitchell (2012) did not find evidence to support that presumption after conducting an extensive analysis of the Western Australian government service delivery agencies.

In Section 5 of this Report, the staffing implications of the current fiscal strategy are considered in some detail. It is noted that in effect the on-going efficiency dividends amount to nothing more than spending cuts to the service delivery capacity of the public sector in Western Australia.

Combined with explicit cuts to specific programs, the ongoing efficiency dividends have reduced public sector staffing. The evidence suggests that arbitrary efficiency dividends have long since harvested available efficiency gains so that further cuts are reflected in increased stress for remaining staff attempting to provide high quality services in a constrained environment and this has a detrimental impact on both the quantity and quality of public services (see Cook, Quirk and Mitchell, 2012). There have been notable instances, such as shared services reforms, where staffing cuts have occurred on the assumption that savings would be achieved but savings have fallen short of expectations, placing an increased burden on staff.

The reasonable null hypothesis that draws on the available evidence is that the on-going cost cutting is now extremely damaging to the integrity of public service delivery in Western Australia.

As a result, the on-going imposition of these efficiency dividends has to be questioned. The Government should be required to demonstrate their assessment of the impact of the cost cutting on the quality and scope of delivered services and to demonstrate why the vast evidence, which indicates that such strategies are undermining the capacity of the public sector to deliver such services is wrong.

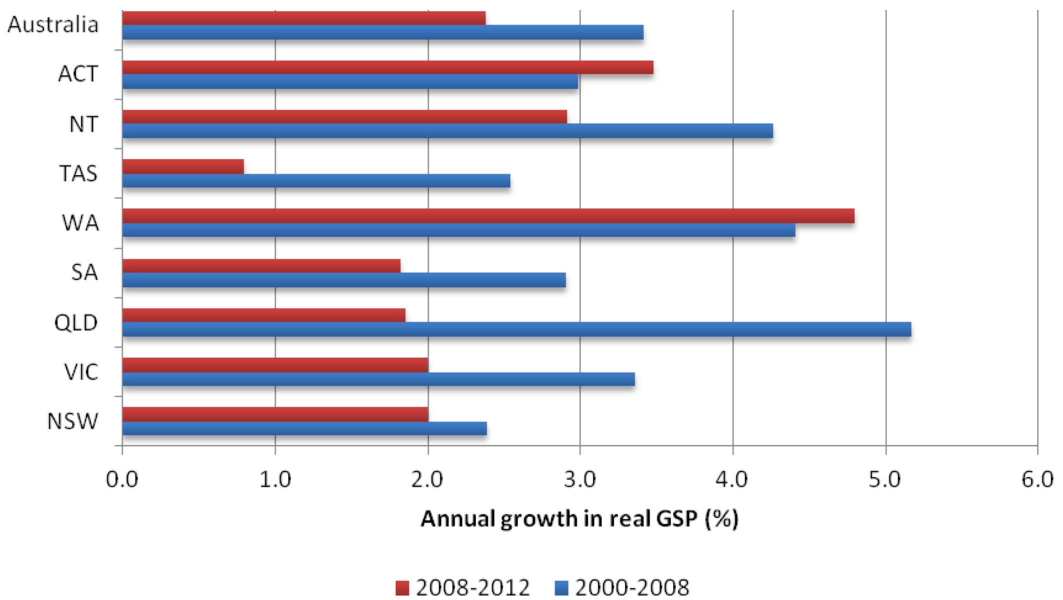
4. The Western Australian Economy

4.1 Economic growth

Since the onset of the Global Financial Crisis, the Australian economy has outperformed other major economies. In 2009-10 the national economy grew by 1.4 per cent compared to a contraction of 3.2 per cent in advanced economies. The Western Australian economy was a standout performer in this regard and grew strongly throughout.

Since 2008-09, the Australian economy has averaged 2.4 per cent real GDP growth per annum and started slowing in 2011-12 as the fiscal stimulus was withdrawn. However, the Western Australian economy continued to grow, averaging 4.2 per cent per annum over the same period as commodity prices resumed growth after dipping in 2008-09. Figure 3 compares annual real output growth for Australian states and territories and the national economy for the periods 2000-2008 and 2008-2012. The impact of the GFC is evident for the national economy and all states bar Western Australia.

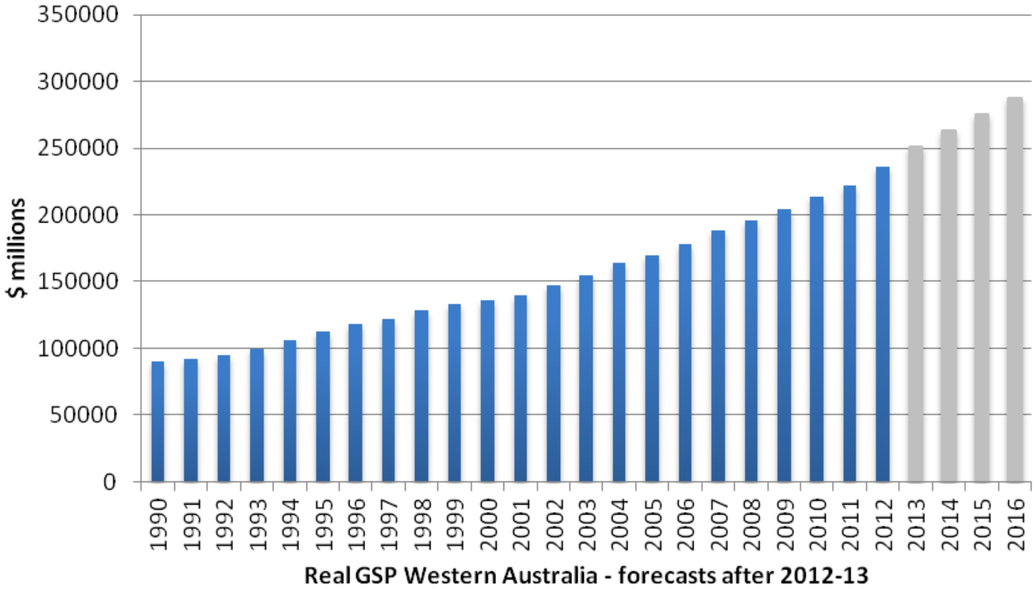
Figure 3 Annual growth rate of Gross State Product, States and Territories and Gross Domestic Product, Australia, 2000-2012, per cent.



Source: (ABS, 2009a), Cat no. 5220.0 Australian National Accounts: State Accounts, Table 1 Gross State Product, Chain volume measures and current prices.

Figure 4 shows the evolution of real Gross State Product (GSP) in Western Australia from 1990-91 to 2011-12, supplemented with the forecasts for the period 2012-13 to 2015-16 provided by the Western Australian Treasury (2013). Figure 2 shows that GSP growth has been very stable over the entire period with only minor deviations from trend growth. The GFC impact was minor and the renewed growth spurt in Western Australia was robust and likely to be sustained.

Figure 4 Real GSP and estimated GSP, Western Australia, 1990-2016, $ millions



Source: Australian Bureau of Statistics, 5220.0 - Australian National Accounts: State Accounts, 2010-11. Forecasts for 2012-13 to 2015-16 from Western Australia Treasury (2013).

Table 3 shows the annual growth in real Gross State Product (GSP) for all states and territories and real Gross Domestic Product for Australia from 1999-00 to 2011-12 (the latest data available from the Australian Bureau of Statistics).

It supports the view that real economic growth in Western Australia fell below trend in 2008-09 as the mining sector lost impetus. But that slowdown was quickly reversed once commodity prices recovered. It is clear that Western Australia is leading the way in Australia at present as a result of the mining boom.

The Western Australian economy is enjoying a two-fold source of prosperity, which will underpin growth for several years. First, commodity prices have boomed. They are now moderating but still remain well above past levels. Second, there has been a massive increase in private capital investment in the mining sector in response to these record commodity prices.

Table 3 Annual growth in GSP and GDP, 1999-00 to 2010-11, per cent

	NSW	VIC	QLD	SA	WA	TAS	NT	ACT	Australia
1999-00	4.4	4.0	4.3	1.9	2.3	1.7	6.5	2.9	3.8
2000-01	1.8	1.1	2.9	2.6	2.4	-0.7	2.7	3.2	1.9
2001-02	1.7	4.3	6.9	4.3	5.8	3.6	4.4	2.8	3.9
2002-03	2.1	3.6	3.8	2.2	4.9	3.1	1.5	4.7	3.2
2003-04	2.5	4.0	6.6	4.4	6.2	5.0	2.8	1.7	4.1
2004-05	1.8	3.8	6.0	1.6	3.0	2.4	4.4	2.1	3.2
2005-06	2.1	2.1	5.6	1.4	4.8	2.5	3.2	2.0	3.0
2006-07	2.1	3.8	5.7	2.0	6.2	2.8	5.7	4.4	3.8
2007-08	2.9	3.4	4.8	5.9	4.0	3.0	7.0	3.0	3.8
2008-09	0.8	0.9	0.6	1.6	3.9	1.9	4.5	3.5	1.4
2009-10	2.2	2.3	1.7	1.2	4.3	0.4	1.3	3.2	2.3
2010-11	2.2	2.5	0.2	2.4	3.5	0.8	1.6	2.8	2.1
2011-12	2.4	2.3	4.0	2.1	6.7	0.5	4.4	3.5	3.4
Average	2.3	2.9	4.2	2.6	4.5	2.0	3.8	3.1	3.1

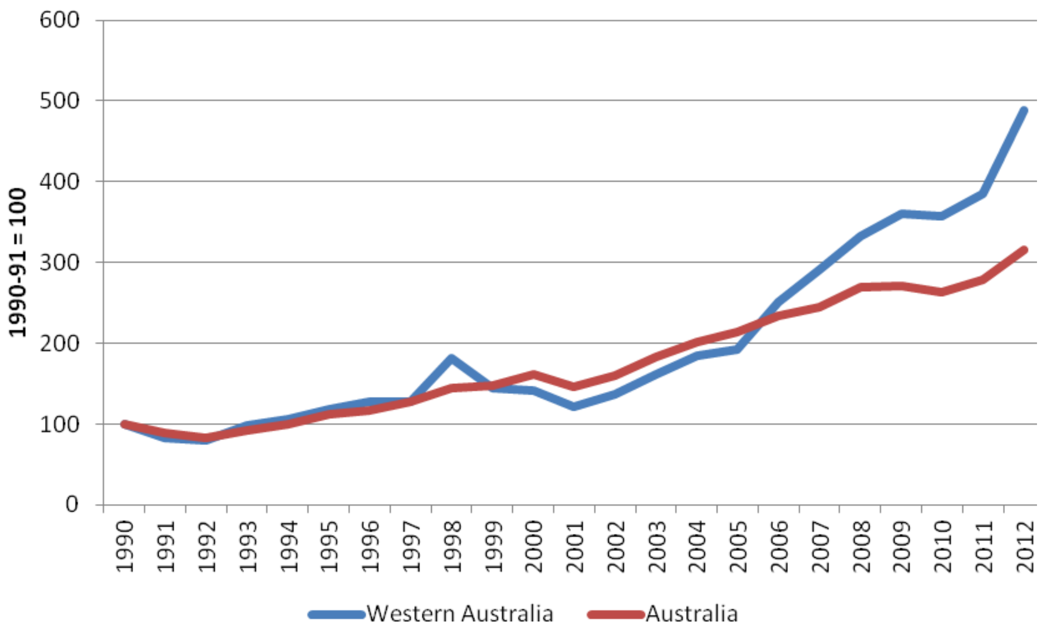
Source: Australian Bureau of Statistics, 5220.0 - Australian National Accounts: State Accounts, 2011-12.

4.2 Private Capital Formation

Figure 5 compares the growth in private capital formation in Western Australia and the national economy for the period 1990 to 2012. The gap between the two series opened up and accelerated as the commodity prices

In the immediate period, the commodity price boom and flow of private investment has driven the strong growth evident in Figure 3. Once the construction phase is over, the higher output levels that will flow from the mining sector as a result of the extra capacity being built will provide for sustained state income gains for many years to come.

Figure 5 Private capital investment indexes, Western Australia and Australia, 1990-2012, June 1990 = 100.



Source: Australian Bureau of Statistics, Cat no. 5220.0 Australian National Accounts: State Accounts Table 6 Expenditure, Income and Industry Components of Gross Domestic Product, Australia, Chain volume measures and current prices and Table 10 Expenditure, Income and Industry Components of Gross Domestic Product, Australia, Chain volume measures and current prices.

4.3 Commodity prices and the Western Australian economy

The WA Treasury paper (2013: 2) notes that:

> The forward estimates are highly sensitive to volatile commodity prices (particularly iron ore) and ratings agencies have indicated that the State's triple-A credit rating is at risk of being downgraded. This highlights the need to constrain expenditure growth in line with revenue growth, with an appropriate and significant surplus as a buffer against this volatility.

The uncertainty surrounding our recent record terms of trade (the ratio of export prices to import prices) relates to whether they reflect cyclical factors or constitute a structural shift, which will underpin a permanent increase in our national income levels.

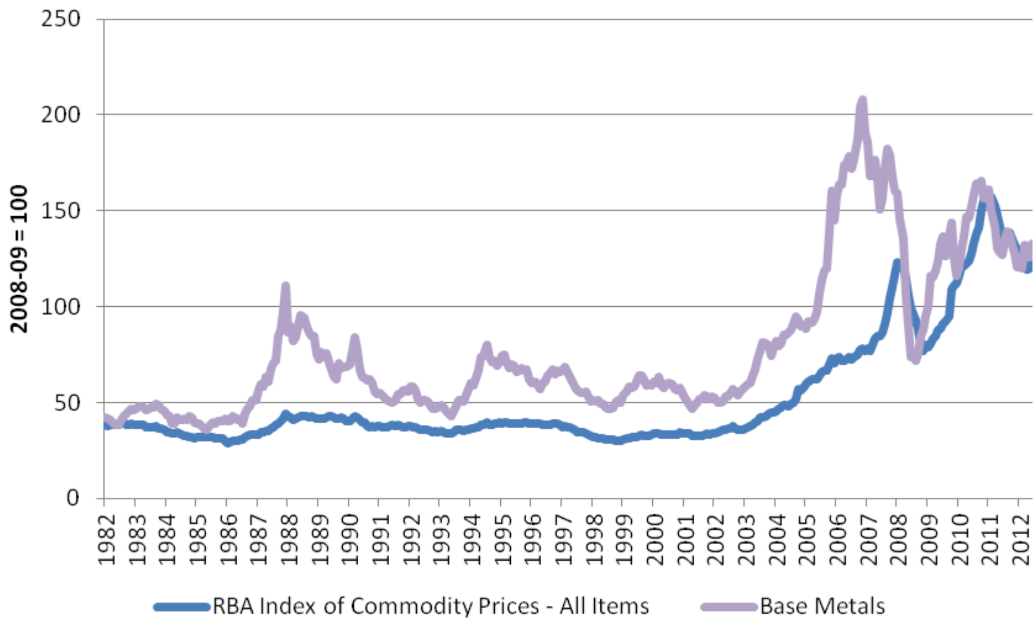
It is clear that there is a strong cyclical element to the movement in commodity prices. Figure 6 shows the Reserve Bank of Australia Index of Commodity Prices and the Base Metal Commodity Prices (2008-09=100) from July 1982 to January 2013 expressed in terms of the US dollar. While the Base Metals series has been more volatile than the broader aggregate, both were relatively stable until late 2003, early 2004.

The first commodity price boom pushed prices to record levels (the Base Metals Index peaking at 208.3 in May 2007) and was interrupted in 2007 by the onset of the Global Financial Crisis (GFC), which saw the Chinese economy slowdown for a time.

The recovery in commodity prices after the downturn, largely due to the fiscal stimulus measures introduced by the Chinese government, saw prices peak at a lower level (164.2 in February 2011) than was experienced pre-crisis. Since that time the index has fallen and is currently stable at around 132.

The commodity price cycle clearly benefitted the Australian economy in general, and the Western Australian economy, in particular. It boosted taxable profits in the minerals sector and spawned a massive investment cycle as mining firms sought to construct productive infrastructure in order to capitalise on the price boom.

Figure 6 RBA Index of Commodity Prices – US dollar terms, July 1982 to January 2013, 2008-09=100

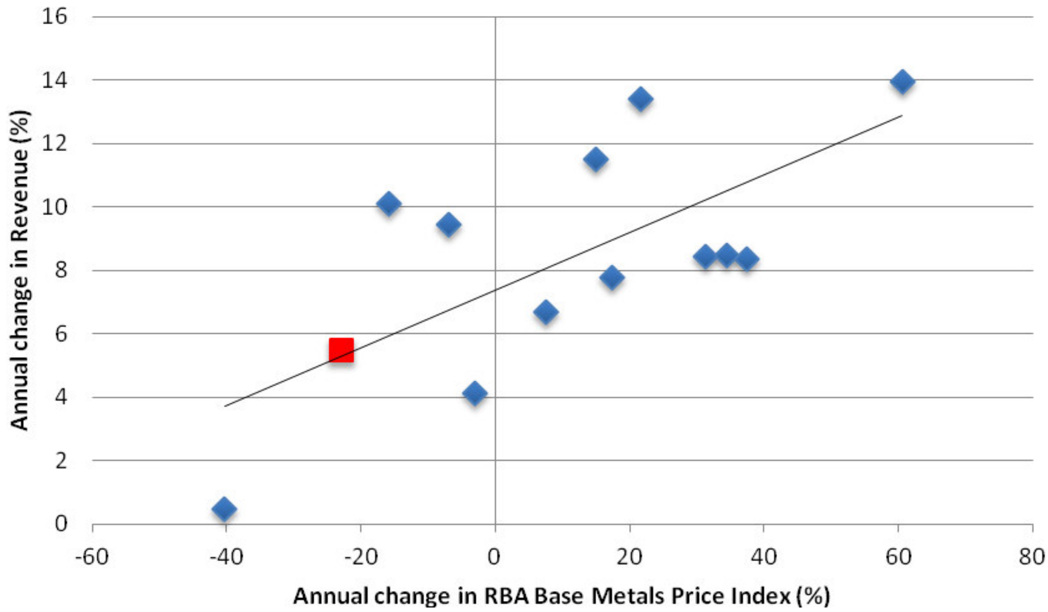


Source: Reserve Bank of Australia, Commodity Price Indexes.

The impact of the strong real GDP growth that accompanied the commodity price cycle on government revenue is clear. Figure 7 plots the relationship between the Annual change in the RBA Base Metal Price Index (horizontal axis) and the annual change in Western Australian government revenue for the period 1999-00 to 2011-12. The solid black line is a simple linear regression. More sophisticated econometric analysis reveals that there is a highly significant relationship between commodity price movements and state revenue, which is stylised by the simple linear regression line.

The red square observation is for 2011-12, the most recent actual budget information available.

Figure 7 Annual change in Western Australian government revenue and Base Metal Commodity Prices, 1999-00 to 2011-12.



Source: Western Australian Budget Papers, various, Reserve Bank of Australia, Commodity Price Indexes.

It is clear that the Western Australian government is adopting a cautious line with respect to the future movement in commodity prices.

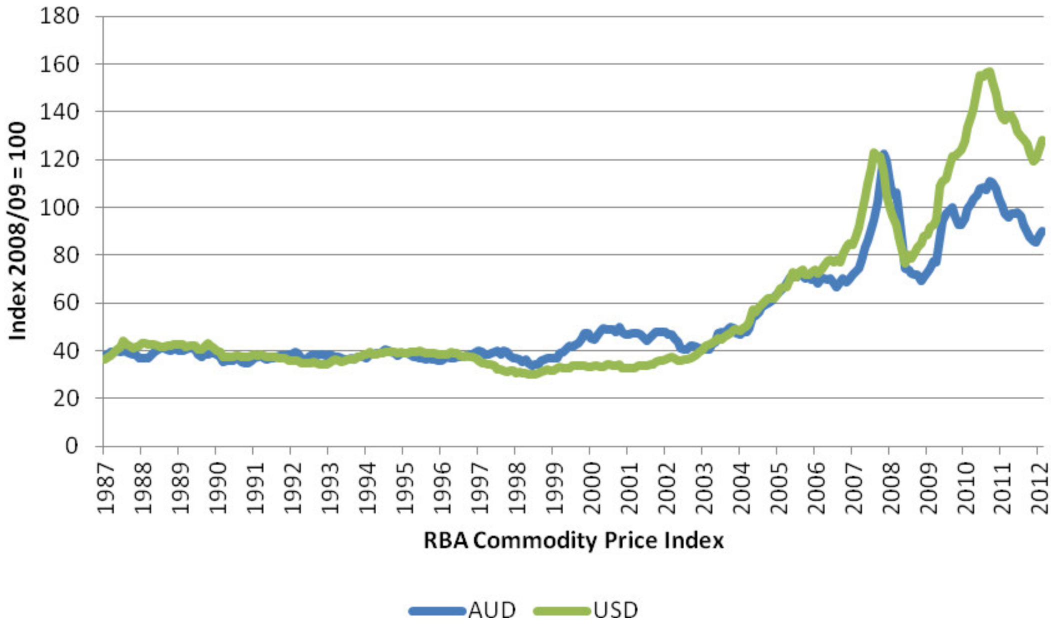
There are two competing views on the direction of commodity prices. Are the shorter cycles associated with the GFC and the ensuing recovery period overlaying a longer cycle since 2004, which is incomplete? The implication of this view is that commodity prices will fall further and not establish a new, higher steady-state level. Alternatively is the rise in commodity prices, the GFC cycle notwithstanding, signalling a structural improvement in the terms of trade? The implication is that while the price level will moderate somewhat, a new higher floor level will be sustained and a new cycle will emerge from that level in the future.

Figure 8 shows the RBA Commodity Price Index valued in US dollars (USD), which captures world price movements in commodities and the Australian dollar (AUD). The RBA also provide a time series specified in terms of the IMF Special Drawing Rights, which expunges exchange-rate valuation impacts on the commodity prices. The SDR series closely follows the USD series.

The data shows that USD series has scaled new heights in the recovery after the GFC. However, that is largely because the USD has depreciated against other major currencies and is therefore, largely, a valuation effect. Commodity prices in Australian dollar terms have been much more subdued.

The growth in world commodity prices is the product of increasing demand from the industrialisation and urbanisation process in China combined with increasing supply constraints in the resources sector.

Figure 8 RBA Commodity Price Index, USD and AUD, 1987 to 2012, 2008/09=100



Source: Reserve Bank of Australia, Commodity Price Indexes.

While the commodity price cycle may have peaked now, it remains that the Chinese process of structural transformation has many years left to go and demand will remain strong.

The question is how long the supply constraints that have been present over the last five years will persist. It is likely that the lagged response to the higher commodities prices will lead to higher supply capacity in the coming decade as a result of the major investment that resource-rich nations have made in building new infrastructure. While this will underpin strong income growth through export volume increases, the increased supply will temper any demand-pull influences on price.

Further, there will be a shift from the investment spending that was required to construct the new supply capacity to export income. The net effects of these shifts are difficult to forecast but the outlook definitely remains positive for resource-rich economies such as Western Australia.

The WA Treasury paper (2013: 2) notes that:

> Economic growth over the outyears is expected to be broadly in line with long-run average growth at 4.25%, with a rebalancing of growth away from business investment towards exports as the construction phase of major resource projects is completed and production commences.

The relevant question is what is likely to happen if commodity prices fall significantly.

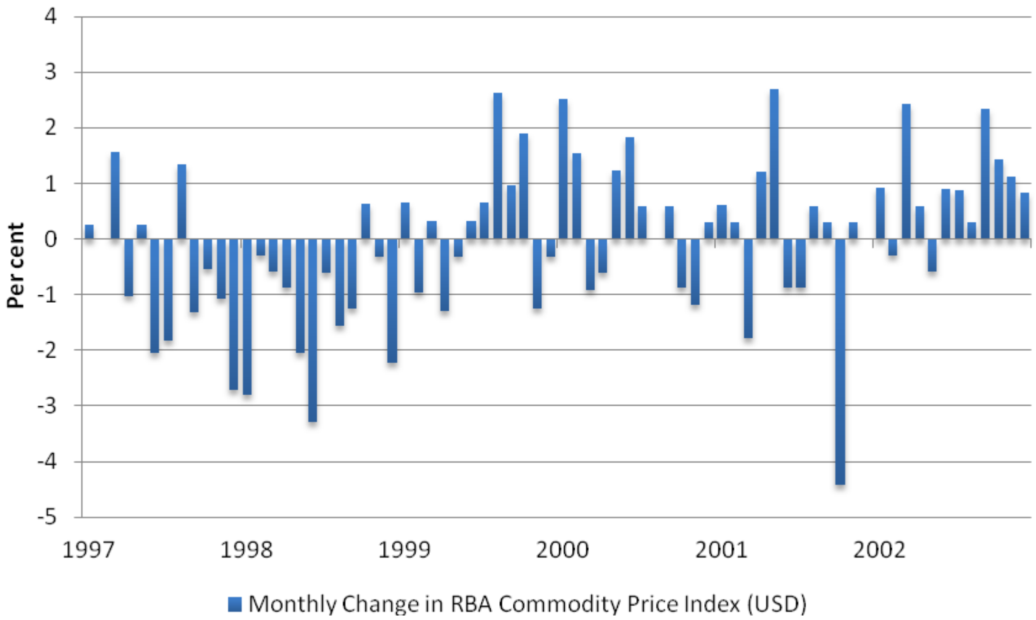
There are two points to note here. First, long-term spending decisions should not be based on cyclical events, such as the volatility of commodity prices. Second, it is worth considering what happened when the commodity prices last declined across the board. That was in the late 1990s.

Figure 9 shows the monthly change in the RBA Commodity Price Index in US dollar terms between January 1997 and December 2002. The sharp decline in world commodity prices, which began in mid-1997 saw mining investment fall significantly in 1999 (-12.9 per cent), 2000 (-25.6 per cent) and 2001 (-9.8 per cent) (see ABS National Accounts, Table 52. Private Gross Fixed Capital Formation, by Industry - Current prices and deflators from Table 4. Expenditure on Gross Domestic Product (GDP), Implicit price deflators).

The falling commodity prices in 1998-99 led to the decline in real GDP growth in Western Australia in that year and the following two years (with negative growth in 2000-01 of -1.2 per cent). However, the WA economy bounced back strongly in 2001-02 on the back of strong investment chasing the renewed commodity price cycle.

The commodity price rebound since 2002 led to a catch-up in mining investment after the sharp reductions in productive capacity in the late 1990s. The investment cycle is now almost complete and increased output will sustain the WA economy for some years to come.

Figure 9 Monthly change in the RBA Commodity Price Index, USD, January 1997-December 2002



Source: Reserve Bank of Australia, Commodity Price Indexes.

The conclusion is that commodity prices are being driven by longer-term forces associated with the industrialisation and urbanisation of China, which will continue for many years to come.

The volatility in the commodity price index will not be eliminated but the trend will remain very positive and it is unlikely that the level common prior to 2004 will be re-established.

The current level is likely to moderate somewhat as the supply capacity improves as a result of the massive investment that has taken place over the last decade or so in the Western Australian mining sector.

But as the prices received will decline, the volumes to meet the on-going demand from China will increase. While it is impossible to predict the net impact on Western Australian Gross State Product and income of these trends, it is highly unlikely that the economy will flounder in the ensuing future.

We would advise against adopting fiscal austerity based on pre-conceived notions that commodity prices will collapse.

5. Public sector staffing developments

5.1 Introduction

Cook, Quirk and Mitchell (2012) provide a detailed analysis of public employment trends in Australian states and territories. They document how public sector employment played the key role in facilitating the virtual elimination of unemployment for the thirty years following WWII until the policy was abandoned in the mid 1970s.

The public sector was also integral to the redistributive aspects of the welfare state, directly providing health, education, employment, and other services as well as operating government business enterprises (GBE) including essential services such as telecommunications, electricity, gas and water. The neo-liberal challenge to this traditional role from the early 1980s was driven by the need for new areas of operation for private corporations, ideological preferences for small government and private sector dominance in the marketplace.

By embracing New Public Management (NPM) Governments have articulated the objective of transforming the public service from being bureaucratic, input-focused and process-driven, to becoming a what they allege is a dynamic, output-focused, efficient and effective organisation.

Such ambitions commenced with the Coombes Commission in 1976 and continued through the Reid Report in 1983 and the Public Service Act 1999 (Cook, 2006). The Hawke federal government instituted managerialist reforms from the mid 1980s, coinciding with the balance of payments and exchange rate crises and the introduction of the Structural Efficiency Principle under the Accord. The government streamlined functions and agencies in 1986, and then amalgamated departments to form mega departments in 1988.

From 1988, commercial practices were introduced in government business enterprises (Bureau of Industry Economics, 1995). State governments implemented similar policies. From the 1990s governments increasingly adopted the purchaser-provider split model which entailed separating the policy and service delivery sections of agencies and embracing the "steering not rowing" agenda articulated by Osborne and Gaebler (1993) that promoted privatisation.

Subsequent privatisation policies further reduced public sector employment with significant adverse consequences flowing throughout the economy and society. Privatisation agendas have been vigorously pursued by governments of both persuasions in Australia at the Commonwealth and State levels.

Mitchell (2001) demonstrated that declining public sector employment contributed significantly to persistently high unemployment in an environment where private sector employment growth failed to match labour force growth. From the mid 1980s public sector employment growth slowed, then in the recession in the early 1990s pro-cyclical job losses exacerbated unemployment, and a large number of public sector jobs were destroyed in the late 1990s.

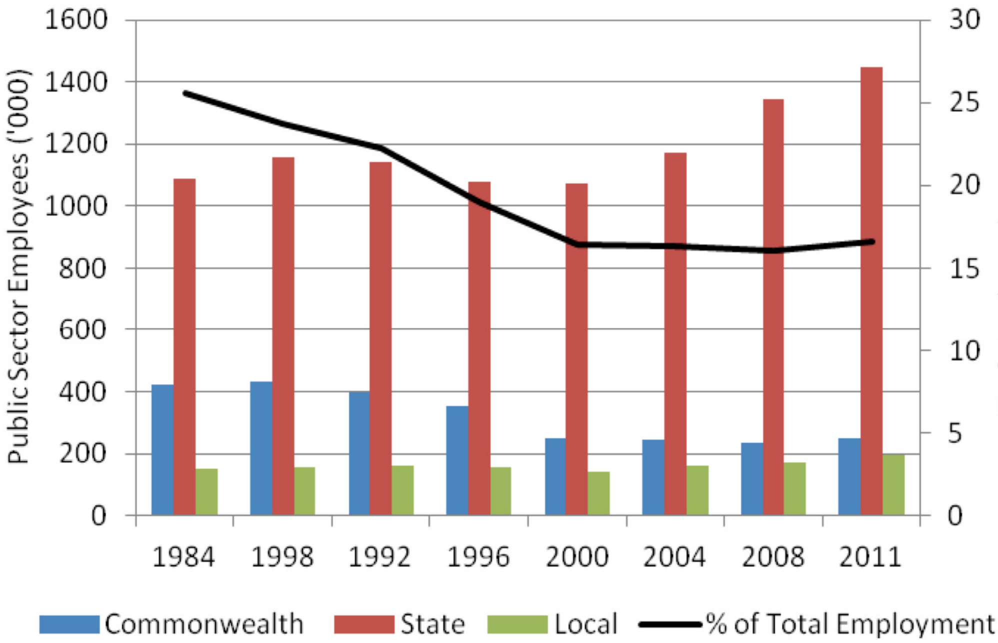
Public sector employment has also been affected by government industrial relations policies at the federal and state level, including the introduction of enterprise bargaining from 1992, and individual Australian Workplace Agreements (AWAs) as part of the *Workplace Relation Act* 1996, which also limited trade union access to workplaces, reduced employment conditions as part of the award simplification process, and transferred workers from paid rate to minimum rate awards, eroding pay over time (Verspaandonk and Holland, 2003). Enterprise bargaining ended the strategy of service wide industrial campaigns spearheaded by strategically important workers while corporatisation, contracting out and privatisation similarly weakened the industrial strength of public sector workers, or created private sector workers with less bargaining power than their public sector counterparts.

5.2 National trends

Cook, Quirk and Mitchell (2012) show that between 1984 and 2011, a period where total employment grew by almost five million, public sector employment increased by only 235,400 (from 1,660,700 to 1,896,100) and its employment share declined significantly.

Figure 10 shows Commonwealth, State and Local public sector employment (columns) and public sector employment share (line) in Australia between 1984 and 2011. The data is at May of each year to 2004 and then June for 2008 and 2011. Over the period, the share of total employment located in the public sector fell from 25.6 per cent to 16.6 per cent. Commonwealth employment declined in both absolute and relative terms, falling from 421,900 in 1984 to 251,400 in 2011. State and Local Government employment increased in absolute terms but at a much slower rate than total employment growth.

Figure 10 Public sector employment, Australia, 1984 to 2011



S
ource: ABS (2007) Wage and Salary Earners, Public Sector, Australia, 6248.0.55.001; ABS (2011)

Employment and Earnings, Public Sector, Australia, 6248.0.55.002; ABS (2011) Labour Force, Australia, Cat no. 6202.0.

The largest fall in total public sector employment occurred between 1992 and 2000 when public sector employment shrank from 22.2 per cent to 16.4 per cent of total employment. This period coincided with substantial reductions in the number of Commonwealth public sector employees in the final years of the Keating ALP Government (employment declined from 397,000 in May 1992 to 354,800 in May 1996). Commonwealth employment was slashed during the Howard Coalition Government to reach only 237,100 by June 2008. The number of Commonwealth public sector employees then increased to 251,400 in June 2011.

The industry composition of public sector employment has changed dramatically over the past thirty years. Education, government administration and defence, and health and community services have dominated government employment, growing from 54 per cent of public sector employment in 1983 to 86 per cent in 2011. Between 1983 and 2011 public sector employment increased from 342,700 to 591,200 in education, 277,700 to 598,500 in government administration and defence, and 268,800 to 431,400 in health and community services. Staffing reductions in transport and storage, electricity, gas and water, communication services, finance and insurance, and manufacturing reflect government privatisation policies.

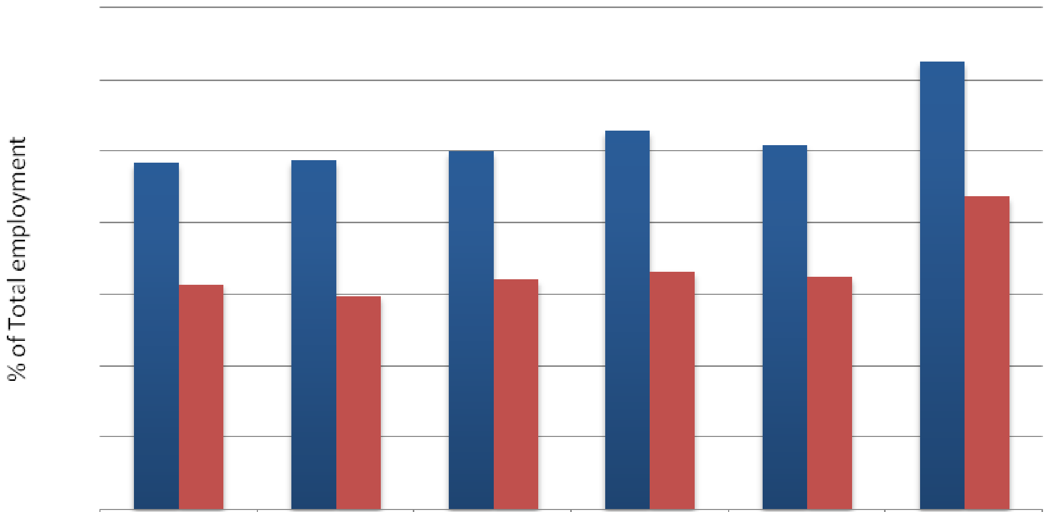
5.3 State public sector staffing in Australia

Figure 11 shows the employment share of state public sector employment for all states between 1984 and 2011. In 1984, Tasmania had the highest proportion of employees working in the public sector at 31.2 per cent. The other states ranged from 24.2 per cent in NSW to 26.5 per cent in South Australia. By 2011 the employment share had declined to between 14.9 per cent in Victoria to 21.8 per cent in Tasmania.

Figure 12 shows the level of state public sector employment for Australian states between 1984 and 2011. The most populous states have the highest level of state public sector employment. NSW employment increased from 349,600 in 1984 to 444,700 in 2011. Employment in the NSW state public sector was relatively flat throughout the 1980s and 1990s but then increased in the past decade. In Victoria there was a significant decline in employment levels in the 1990s (employment fell from 314,000 in 1988 to 217,700 in 1997) before increasing continually through to 2011.

The highest growth rates occurred in Queensland (1.99 per cent) and Western Australia (1.34 per cent), which may be attributable to increasing demand due to a faster rate of population growth. Queensland state public sector employment has grown more quickly than other states, rising from 178,300 in 1984 to 303,400 in 2011. Employment levels in the Western Australia state public sector remained relatively flat until 2003 but then increased from 118,000 to 166,600 by 2011.

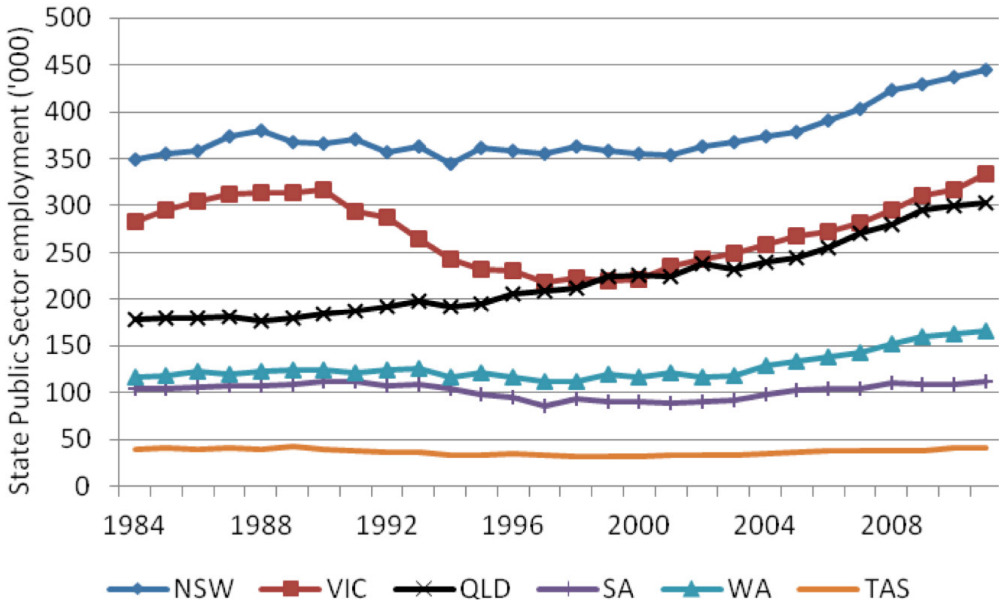
Figure 11 Total public sector employment and share by state, 1984 to 2011



	NSW	Vic	Qld	SA	WA	Tas
1984	24.2	24.4	25.0	26.5	25.4	31.2
2011	15.7	14.9	16.1	16.6	16.2	21.8

Source: ABS 6248.0.55.001 Wage and Salary Earners, Public Sector, Australia; ABS 6248.0.55.002 Employment and Earnings, Public Sector, Australia, 2010-11; ABS 6202.0 Labour Force Australia.

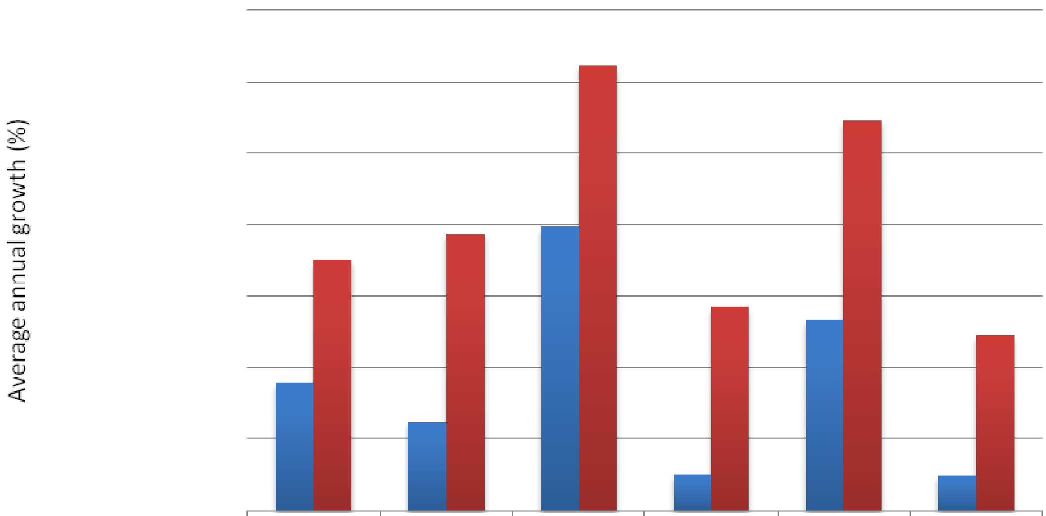
Figure 12 State public sector employment, 1984 to 2011, 000s



Source: ABS (2007) Wage and Salary Earners, Public Sector, Australia, 6248.0.55.001; ABS (2011) Employment and Earnings, Public Sector, Australia, 6248.0.55.002.

South Australia and Tasmania have experienced virtually no growth in state public sector employment throughout the period (an average of around 0.24 per cent per annum). Employment fell sharply in Victoria in the 1990s (from 316,300 in 1990 to 221,500 in 2000) and finally surpassed the 1990 employment level in 2010. While the growth rate for NSW for the entire period was 0.90 per cent, employment levels were fairly stagnant until the mid early 2000s and then increased significantly.

– Figure 13 Growth rate of State public sector staffing compared to the growth rate of total state employment, 1984 to 2011



	NSW	VIC	QLD	SA	WA	TAS
State Public Sector	0.9	0.6	2.0	0.2	1.3	0.2
Total employment	1.8	1.9	3.1	1.4	2.7	1.2

Source: ABS 6248.0.55.001 Wage and Salary Earners, Public Sector, Australia, Jun 2007; ABS 6248.0.55.002 Employment and Earnings, Public Sector, Australia, 2010-11; ABS 6202.0 Labour Force Australia.

Despite the fact that all states have experienced some increase in public sector employment levels during the period, the rate of growth has been substantially lower than the growth of total employment. This phenomenon is clearly shown in Figure 13. In all states the growth in total employment has been greater than the growth rate for state public sector employment.

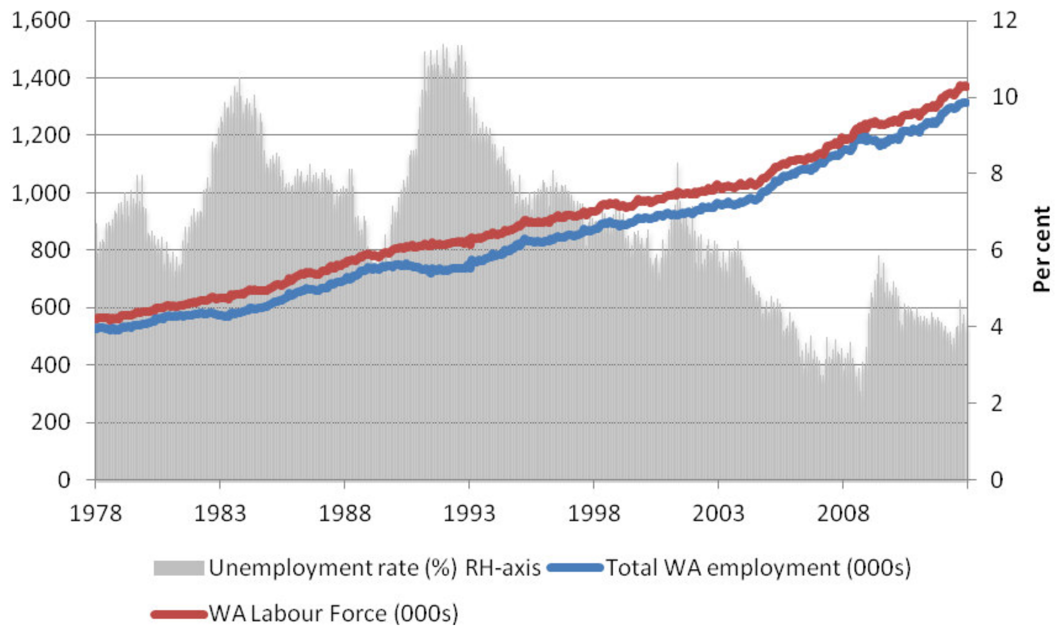
Total employment grew by an average of 3.1 per cent per annum in Queensland while state public sector employment increased at the slower rate of 2.0 per cent. Similarly state public sector employment increased more slowly than total employment in all other states, with the lowest state public sector growth rate of only 0.2 per cent in South Australia and Tasmania.

5.4 Overall labour market trends in Western Australia

Figure 14 shows the evolution of total employment (000s), the labour force (000s) and the unemployment rate (%) in Western Australia from February 1978 to January 2013. The difference between the total employment lines is the official unemployment and the unemployment rate is the total unemployment expressed as a percentage of the labour force.

The data shows that the Western Australian labour market has improved in performance since the recession of the early 1990s. Before the GFC, the unemployment rate was well below the national average. While it is still below the national average, the recovery has not yet been strong enough to return to its previous lower level.

Figure 14 Employment, Labour Force and Unemployment, Western Australia, February 1978 to January 2012, 000s

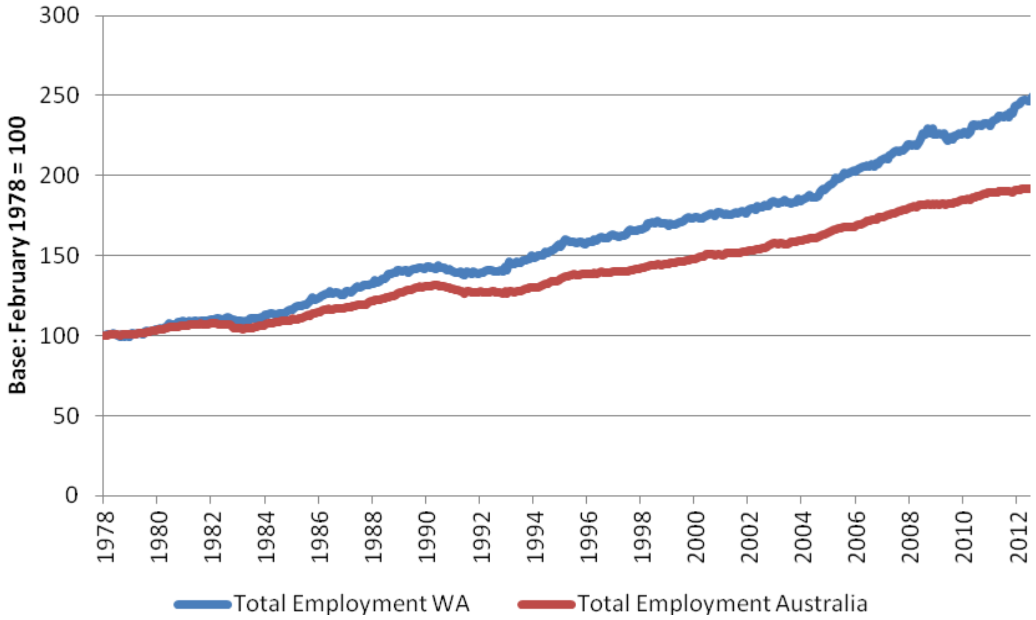


Source: ABS Labour Force.

To put this performance in perspective, Figure 15 plots employment indexes for Western Australia and Australia (February 1978=100). The Western Australian labour market recovered more robustly from the 1991 recession than the overall nation. The divergence in employment growth began however in the 1980s and has continued to accelerate, notwithstanding the cyclical events.

Since January 2000, total employment in Western Australia has grown by 44.5 per cent compared to the national average of 30.5 per cent.

Figure 15 Total employment indexes, Western Australia and Australia, 1978-2013, February 1978=100

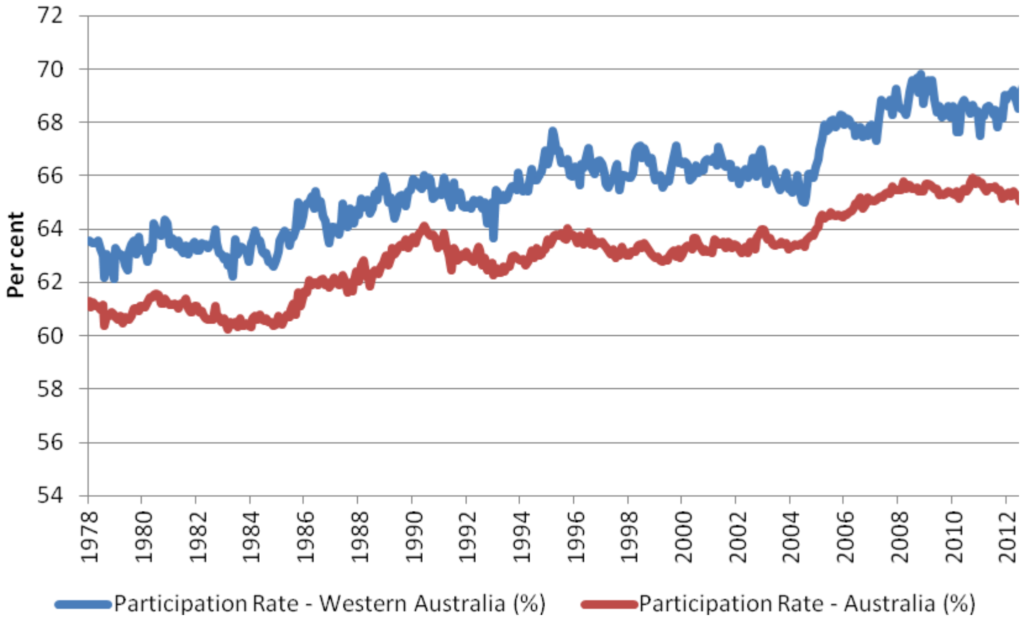


Source: ABS Labour Force.

Figure 16 compares participation rates in Western Australia and Australia Western Australia from February 1978 to January 2013. The former has consistently had a higher participation rate. Most significantly, in the current period, even though participation rates fell in the state and nation as a whole with the onset of the GFC as job opportunities were scarce, the WA labour market has recovered while participation rates in Australia remain well below their previous peak.

This has implications for the evolution of the unemployment rate. The WA labour market is generating strong employment growth but also facing much stronger labour force growth. In contrast, the unemployment levels in Australia overall are being held down by the fact that participation rates have fallen sharply, which means that official unemployment is lower than otherwise but hidden unemployment is higher.

Figure 16 Participation rates, Western Australia and Australia, February 1978 to January 2013, per cent



Source: ABS Labour Force.

5.5 State government employment in Western Australia

Cook, Quirk and Mitchell (2012) provide a detailed analysis of public sector employment in Western Australia up to 2011. In this section, we update some of that analysis.

Table 4 shows the annual growth in state public sector employment for the years spanning 2007-08 to 2011-12. Prior to 2010-11, growth in the Western Australian public sector was above the national average although the gap was slowing. Over the last two fiscal years, it is clear that contraction in public employment has been sharp in Western Australia. There is no argument that can be made that there is an explosion in state government workers.

Further, in assessing whether the scale of the overall state public sector employment is comparable the Table also shows the number of public servants per 1000 population. It is expected that states with the largest population share will have a smaller number of public servants on a per capita basis due to scale efficiencies. We also have to take into account population density.

As a result of the contraction in public employment in Western Australia, the number per 1000 persons is around that of South Australia and Queensland despite the fact that South Australia has a significantly smaller population than both these states. If the South Australian public sector is relatively lean, then this would suggest that the job cutting enforced as a result of the efficiency dividend in Western Australia has been excessive.

Table 4 State Government employees, Per 1000 persons and Annual growth, per cent, 2007-08 to 2011-12

	NSW	VIC	QLD	SA	WA	TAS	NT	ACT	Australia
Per 1000 persons									
2007-08	61.0	56.3	66.2	69.8	70.8	76.9	100.7	56.9	63.2
2008-09	61.1	57.9	68.2	67.7	71.5	75.9	105.6	61.8	64.1
2009-10	61.4	58.2	68.2	67.4	71.5	80.7	105.7	63.4	64.4
2010-11	62.5	60.0	68.0	67.3	71.5	78.8	103.6	65.8	65.1
2011-12	62.0	59.0	66.8	68.9	68.9	75.8	106.4	66.7	64.3
Annual Growth (%)									
2007-08	7.3	8.0	7.2	7.4	9.7	4.3	8.8	3.4	7.6
2008-09	1.5	4.9	5.4	-2.1	4.4	-0.3	7.7	10.7	3.3
2009-10	1.7	2.1	1.7	0.6	2.3	7.3	2.1	4.6	2.0
2010-11	2.8	4.4	1.0	0.5	2.3	-1.7	-1.2	5.7	2.4
2011-12	0.2	-0.3	-0.2	3.2	-0.7	-3.5	3.8	3.3	0.1

Source: Australian Bureau of Statistics, 6248.0.55.002 - Employment and Earnings, Public Sector, Australia, 2010-11 and 3101.0 - Australian Demographic Statistics, Jun 2012.

Figure 17 shows the evolution of the State government employment rate for Western Australia and all states and territories between 1984-84 and 2011-12. The rate is the calculated as the proportion of state government wage and salary earners in the labour force and allows us to see whether public sector employment has kept pace with the growth of the labour force (and by implication, growth in the overall population).

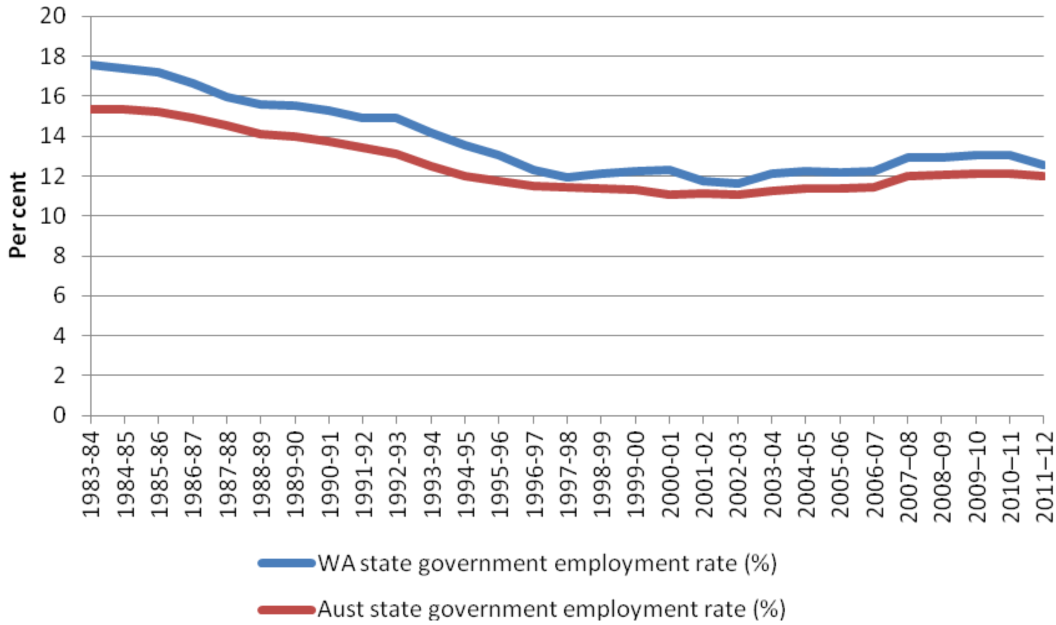
ABS Labour Force data shows that between 1983-84 and 2011-12, Western Australian public sector employment rose by 44.6 per cent. Over the same period the Western Australian labour force more than doubled (Index change of 102.6).

By comparison, total public employment in Australia grew by 33.8 per cent while the labour force grew by 70.7 per cent.

The Gallop Labor Government made significant increases in staffing during its first term of government. Between 2001 and 2005 there were an additional 954 teachers employed and class sizes declined for Years 1 to 3. There were 250 extra police officers, 50 additional transit police and 1,346 more nurses in public hospitals (Government of Western Australia, 2005). The Government reduced the use of fixed-term, temporary and casual employment in the public sector, and converted over 4,000 casual or fixed-term positions to permanent positions, including over 2,390 teachers.

Many of the recent staffing increases have been concentrated in the main frontline service areas such as policing, health workers, child protection, education and corrective services.

Figure 17 State public employment rates, Western Australia and Australia, 1983-84 to 2011-12, per cent of labour force



Source: Australian Bureau of Statistics, 6248.0.55.002 - Employment and Earnings, Public Sector, Australia, 2010-11 and ABS Labour Force.

The Barnett Coalition Government introduced FTE ceilings in FTE staffing levels for General Government agencies and a 3 per cent efficiency dividend to apply from January 2009 (2008-09 Government Mid-Year Financial Projections Statement (Government of Western Australia, 2008). The Government also introduced a public sector wages policy from July 2009 that involved tying wage increases to the Perth Consumer Price Index. Any increases above the CPI were required to be linked to improved efficiency, with total increases (CPI plus efficiency) capped at the WA Wage Price Index for all sectors.

The intention to cut public service numbers was re-affirmed in the 2012-13 Western Australian Budget. Budget Paper No. 3 (Page 45) the Government states that they have:

> … implemented a range of measures to control expense growth in successive budgets, such as through a 3% efficiency dividend, targeted savings measures and voluntary separations.

Despite increases in frontline staffing in some areas of the Western Australian public sector, Table 4 shows that public employment shrank overall (-0.7 per cent) in the last fiscal year (2011-12).

The most recent contraction in public employment in Western Australia has been assisted by the acceptance of voluntary redundancy offers, primarily for management and administrative staff. In 2008-09, 469 staff accepted voluntary redundancies and another 300 were offered in 2009-10.

Public servants accepted a total of 1135 voluntary separations in the three years to 2011, which reduced funding needs by around $54 million per annum (2011-12 MYR). Another 336 redundancies were reported in the 2011-12 Budget.

In the 2011-12, the Government restricted growth in public sector staffing to 1.7 per cent for 2011-12 despite the acknowledgement that there is:

> … increasing demand for State government services (e.g. health and education) and infrastructure (e.g. public transport, electricity and water infrastructure). (2011-12 Budget: Economic and Fiscal outlook, Budget Paper No. 3.Page 31)

In the 2012-13 Budget, the Government announced further restrictions on public staffing despite noting the pressures on the provision of public services as a result of population growth.

As one of the highlights in the 2012-13 Budget, the Treasury (2012-13 Budget Paper No.3, page 33) noted that:

> Strong population growth and community expectations are driving increased demand for service delivery.

Despite that recognition, the 2012-13 Budget Paper No. 3 (page 40) reports that:

> … as part of the Government's response to its 2011-12 Budget initiative to achieve general government savings of $300 million, an FTE cap will be implemented in 2012-13 that is equivalent to the approved FTE ceiling levels for 2011-12, with assumed growth only for operational staff in Health, Education and Police, and adjustment for 2012-13 Budget approvals impacting staffing levels.

Further, the 2012-13 Budget Paper No. 3 (page 41) reports that:

> The new savings measures in this budget extend this staff management initiative to also apply in 2013-14, resulting in an estimated $230 million net debt benefit over the forward estimates period. Further restrictions on FTE growth in 2014-15 and 2015-16 will also be implemented to generate savings through lower salary and related employee costs. By limiting FTE growth for the general government sector to 1.5% per annum from 2014-15, it is expected that savings of around $182 million can be achieved over the forward estimates period, while still accommodating increases approved as 2012-13 Budget initiatives.

5.6 The direct consequences of public employment cuts

The logic of imposing efficiency dividends and growth caps public sector employment is that productivity improvements will allow the agencies to maintain the scope and the quality of service.

All state governments in Australia have engaged in cutting public sector staffing due to self-imposed budget constraints. Staffing reductions are generally characterised as being in non-frontline areas, and therefore, have little or no impact on service delivery.

Cook, Quirk and Mitchell (2012) provide the most detailed analysis to date in Australia of the consequences of such staffing strategies and conclude that there are a range of negative consequences that compromise the overall capacity of the public sector to meet its responsibilities.

In an environment of increasing population and increasing demands on the provision of public services these negative consequences are amplified.

There are a number of important possible consequences of public sector staff cuts:

- Direct impacts on frontline workers;
- Loss of highly productive workers and corporate memory;
- Demoralisation of the remaining workforce resulting in reduced efficiency;
- Impact on services.

Impact on frontline staff

While governments claim that reducing back office staff will have a minimal impact on the ability of frontline workers to deliver high quality services to the public, this outcome is not assured. First, there is not necessarily a clear demarcation between the functions performed by frontline service delivery staff and their back office counterparts.

Secondly, even where clearly defined separate roles exist, there is a distinct possibility that some of the functions performed by the back office workers are crucial for frontline workers to delivery services. For example, if non-frontline workers are entering data that frontline workers rely on to work efficiently, any delay in data entry diminishes the quality of the service provided to the community. Reductions in the number of support workers may result in a transfer of administrative functions to frontline workers, diverting them from service delivery. These types of outcomes are counterproductive and impact adversely frontline workers and the quality and quantity of services delivered to the public.

The fact that the majority of public sector workers are already engaged in direct service delivery and the past practice of cutting administrative positions means that it will become progressively more difficult to cut these jobs without causing major disruptions to services. As the proportion of support workers shrinks there is a danger that staffing levels will fall below a critical mass that is essential for services to be delivered efficiently and effectively. Such situations would also be exacerbated by staff taking unrostered leave.

Despite assurances by governments that staff cuts will be concentrated in non-frontline areas, there are losses in service delivery positions that impact directly on the community. This is a particular problem when blanket decisions are made such as staff freezes or allowing fixed-term contracts to lapse.

<u>Loss of productive workers and corporate memory</u>

Voluntary redundancy avoids the acrimony experienced with involuntary redundancy (Clarke, 2007), but increases the risk that the most productive and experienced workers may leave the organisation. There is a danger that a large proportion of workers made redundant are among the most productive and experienced. This is because individuals faced with the prospect of voluntary redundancy assess the benefits of redundancy by weighing up the financial gains of the redundancy package against potential losses from unemployment.

The most productive workers are more likely to secure employment quickly and therefore reap greater financial gains from accepting the package. Those with the best prospects of securing employment elsewhere are more likely to accept the package while those with few employment prospects are likely to seek redeployment because the long-term cost outweighs the short-term benefit of accepting the offer.

Another counter-productive result of skill reduction is if the most productive workers accept voluntary redundancy or early retirement. The danger for the organisation is that losing the most productive workers will impact negatively on productivity and that the less experienced workers who remain require additional training and may struggle to cope with the extra workload. A study of the costs to the SA public service of the original reduction of 1600 FTE by Ranasinghe and Spoehr (2012: 10) highlighted the costs to organisations when experienced workers leave:

> Long-term regular employees gain valuable skills and corporate knowledge over time, gathered by training programs, on-the job training or by many years of professional experience. When such workers leave, they take with them these skills and knowledge. Whilst the cost of this loss is hard to quantify, it has genuine and explicit implications for employers.

Ranasinghe and Spoehr (2012) estimated the sunk costs that could not be recovered when employees leave the public service. Based on the loss of 1913 people (1600 FTE) with a one off recruitment cost of $20,000 per worker and annual training costs of $735 per employee for an average of 18 years, the estimated value of the loss of skills and knowledge was $635,670,660. However, they caution that there are additional costs related to ‘the intrinsic value of experienced workers, which is much harder to measure,’ (Ranasinghe and Spoehr, 2012). The sunk costs will have risen considerably when the subsequent rounds of job losses are included.

A major phenomena identified in the literature is the loss of institutional memory due to downsizing so that efficiency is impaired rather than enhanced (Feldheim, 2007). A GAO (1996: 39) study of downsizing in the US public sector between 2003 and 2006 reported that half of the respondents said that ‘downsizing somewhat or greatly hindered their agency’s mission.’

Negative consequences of downsizing included loss of institutional memory, service shortfalls, skill imbalances, increased use of overtime, increase in work backlogs, lowered morale and the productivity of the remaining workforce. Some organisations estimated that it may take several years to return to the previous skill levels and some had found it necessary to reemploy some of the downsized employees, either directly or on a contract basis.

Demoralisation and reduced efficiency

While organisations downsize to improve efficiency and productivity these outcomes are not guaranteed. The negative consequences for efficiency in downsized organisations is highlighted by Dunford, Bramble and Littler (1998) who describe the effects of work intensification as work that was previously done by specialist staff (such as administrative staff) is redistributed. In addition they contend that in a period where the role of management becomes more critical to manage the process of change, many managers are unable to handle the increased complexity of their role and consequently suffer increased stress and psychological problems.

Absenteeism is frequently viewed as a proxy for worker dissatisfaction. Firns, Travaglione and O’Neill (2006) studied absenteeism in a major public sector transport organisation in Australia during a period of modernisation and downsizing and found that absenteeism increased amongst employees who intended leaving the organisation.

5.7 The wider implications of reductions in public sector staffing

Cook, Quirk and Mitchell (2012) provide a detailed analysis of the broader implications of public sector retrenchment for Australian society.

They highlight the loss of a national skills formation capacity leading to skills shortages, the loss of yardsticks to set decent standards of employment (the leadership role played by the public sector in areas such as non-discrimination, appointment on merit, family friendly conditions, employment security, staff training and development); and the loss of the positive aspects of public bureaucracy (equality of treatment and transparency).

A professional public sector administered social policies: interpreting rules and regulations governing entitlements and payment rates; ensuring uniform service delivery; evaluating program adequacy and effectiveness; and recommending policy changes. Contrasting previous welfare provision by charitable organisations the welfare state machinery ensured that, in the main, beneficiaries in similar circumstances achieved similar treatment.

Outsourcing it has become more difficult to ensure that these principles apply due to a lack of transparency. Integral to the justification for outsourcing functions is the belief that private sector organisations will be more innovative, which necessarily introduces variety into the amount and composition of services. Therefore, the actual service received by two like individuals may vary considerably according to their service provider.

There is also the possibility that clients will be judged according to the beliefs of the organisation providing services. The utilisation of "commercial-in-confidence" clauses and the like to restrict publicly available information raises questions about service delivery.

Moreover, many of the private sector organisations delivering publicly funded services are large bureaucratic organisations that are likely to suffer from the same limitations as public bureaucracies.

5.7 Conclusion on staffing strategies

Government policies over the past two decades have impacted significantly on public sector employment. In addition to the preoccupation with reducing debt and producing budget surpluses, governments at both the federal and state level have pursued privatisation and outsourcing and attacked employment conditions of public sector workers.

Specific policies pursued by governments in Australia have included large rounds of staff cuts in some states, the imposition of staff ceilings, efficiency dividends, attempts to impose freeze wages or to take back long-standing payments and employment conditions.

There are a number of trends that can be identified in the trajectory of state public sector staffing in Australia over the past few decades:

1. Increases in frontline staffing have occurred in response to increased need due to population growth, ageing of the population, the inability of people to satisfy their needs through market activity, growing social problems such as substance abuse, the impact of changes in policies relating to mental illness. There has also been recognition of new areas of need and improved methods of meeting needs identified through research.
2. Expenditure cuts in the form of ongoing efficiency dividends and cuts to specific programs have reduced public sector staffing. The evidence suggests that arbitrary efficiency dividends have long since harvested available efficiency gains so that further cuts are reflected in increased stress for remaining staff attempting to provide high quality services in a constrained environment and this has a detrimental impact on both the quantity and quality of public services. There have been notable instances, such as shared services reforms, where staffing cuts have occurred on the assumption that savings would be achieved but savings have fallen short of expectations, placing an increased burden on staff.
3. Staffing cuts or restrictions due to government imposed budget constraints or privatisation of functions:

a. Mass redundancy exercises have a number of significant negative consequences for staff and service delivery. In the first instance there is a high level of stress for staff that results in a reduction in productive work while the redundancies proceed. The lost of productive workers reduces the overall skill level of the organisation and there is a loss of corporate memory. Some impacts on service delivery include: a decline in the quantity or range of services offered; increased waiting times; increased targeting of services so that many people miss out on services.
b. In the case of cuts to programs, at best, this results in the loss of services that were previously provided to clients. It may also result in exacerbating the problem or causing new problems, which increase costs in the longer-term.
c. FTE ceilings and staffing freezes introduce inefficiencies as agencies are not able to fill important positions. Attempts to circumvent FTE ceilings can result in higher costs, for example, the use of labour hire to obtain workers who are not counted in staffing figures is more expensive than direct employment of staff.

Developments in public sector staffing throughout Australia have been dominated by State Government adherence to neo-liberal policies that have included: (1) erosion of welfare state funding through the reduction of taxation on businesses and high income earners; (2) the imposition of budget constraints on expenditure on public services; and (3) the transfer of service delivery to the private sector through privatisation, PPPs and outsourcing. Compared to their public sector counterparts, private sector workers frequently have lower levels of qualifications and endure inferior wages and working conditions. In effect these workers can be viewed as effectively subsidising the low cost production of services. Moreover, these developments have contributed to the deterioration in skill formation exacerbating skill shortages in the labour market.

6. Demographics

6.1 Overview

Table 5 compares the population profiles for Australian states and territories in the 1991, 2006 and 2011 Census years. It shows that the national population has steadily aged over the period from 1991 to 2011 with an increase in the median age from 32.4 years to 37.3 years. The proportion of the national population aged 0-14 years has decreased while at the other extreme of the age distribution (over 65 years) has risen.

Over the last two decades, Western Australian demography has echoed the national trend although the state has the third youngest oldest population (in median age terms) behind the Territories. The trends in Western Australia and Queensland appear to be similar, which is no surprise considering the net migration into these states from elsewhere in Australia.

Western Australia, Queensland and the NT also have a higher proportion of citizens in the 1-15 year old cohort and below the national average proportions in the aged 85 years and over group. In terms of population growth, the national rate (as at December 2011) was 1.4 per cent per annum. South Australia had the second lowest population growth rate (0.7 per cent per annum) behind Tasmania (0.4 per cent per annum).

The population dynamics have implications for the political choices the government will have to make in terms of service provision.

6.2 Dependency Ratio

The dependency ratio is a key concept in the ageing population debate. The standard dependency ratio is normally defined as 100*(Population 0-15 years) + (Population over 65 years) all divided by the (Population between 15-64 years). Historically, people retired at 65 years and so this was considered reasonable. The working age population (15-64 year olds) then was seen to be supporting the young and the old.

Various other constructs of the dependency ratio are also used in the literature. For example, in recognition that retirement ages might no longer be defined strictly as 65 years, dependency ratios can be calculated for various assumed “retirement ages”. By increasing the retirement age past 65 the usual calculations of the dependency ratio fall markedly for each year that retirement is delayed. We consider that issue in Table 19.

The following projection uses the ABS Series B model which assumes moderate fertility rates (1.8 babies per woman); net overseas migration of 180,000 per year, a life expectancy for males of 85 years and females 88 years and a projected national population of 35.5 million persons by 2056. Series B also assumes "continuing population growth for all states and territories except Tasmania between 30 June 2007 and 2056 ... South Australia is projected to increase by 620,300 people (39%) to 2.2 million people in 2056" (ABS, 3222.0 - Population Projections, Australia, 2006 to 2101).

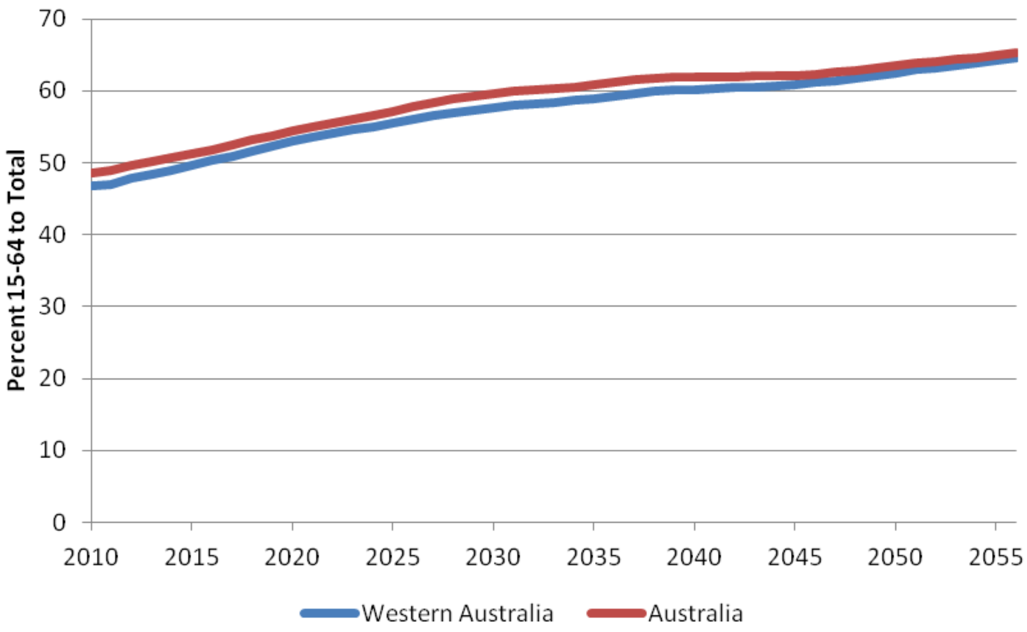
Figure 18 compares the evolution of the dependency ratio for Western Australia and Australia from 2010 to 2056. The estimates suggest that Western Australia will move broadly in line with the national trend notwithstanding the slightly younger population in the state.

Table 5 Age Composition and Median Ages of the Population, At 30 June

	0-14 years			15-64 years			65 years and over			85 years and over			Median Age		
	1991	2006	2011	1991	2006	2011	1991	2006	2011	1991	2006	2011	1991	2006	2011
	%	%	%	%	%	%	%	%	%	%	%	%	Years	Years	Years
NSW	21.6	19.6	18.9	66.6	66.9	66.7	11.9	13.5	14.5	0.9	1.6	2.0	32.9	36.8	37.7
VIC	21.3	19.0	18.2	67.2	67.6	67.8	11.5	13.4	14.0	1.0	1.6	1.9	32.5	36.7	37.3
QLD	22.7	20.4	19.8	66.5	67.5	67.2	10.8	12.1	12.9	0.8	1.4	1.6	31.8	36.0	36.6
SA	20.7	18.3	17.7	66.4	66.6	66.4	12.9	15.1	15.9	1.0	2.0	2.3	33.6	38.8	39.5
WA	**23.2**	**19.9**	**19.2**	**67.1**	**68.3**	**68.7**	**9.7**	**11.8**	**12.1**	**0.8**	**1.3**	**1.5**	**31.5**	**36.2**	**36.3**
TAS	23.1	19.7	18.7	65	65.7	65.3	11.9	14.6	16.1	0.9	1.7	2.0	32.4	38.8	40.4
NT	27.8	24.5	22.6	69.5	70.9	71.8	2.6	4.6	5.5	0.1	0.3	0.3	26.9	30.9	31.4
ACT	23.5	18.8	18.1	70.3	71.7	71.4	6.2	9.5	10.5	0.4	1.0	1.3	29.5	34.4	34.5
AUST	**21.9**	**19.6**	**18.9**	**66.8**	**67.4**	**67.3**	**11.3**	**13**	**13.8**	**0.9**	**1.6**	**1.8**	**32.4**	**36.6**	**37.0**

Source: Australian Bureau of Statistics, 3101.0 - Australian Demographic Statistics, Dec 2011.

Figure 18 Dependency ratio, Western Australia and Australia, 2010 to 2056, per cent



Source: Australian Bureau of Statistics, 3222.0 - Population Projections, Australia, 2006 to 2101

To see the implications of changing the retirement age, Table 6 shows what the dependency ratio would be for different retirement ages in 2056. It is clear that by increasing the retirement age the government can dramatically reduce the dependency ratio. It will clearly be better for the State to keep as many people who desire work in active employment later into their lives than has traditionally been the norm.

Table 6 Simulating impacts of different 2056 retirement ages on Western Australian dependency ratios

Retirement age 2056	Dependency Ratio (%)
65	64.5
66	61.6
67	58.7
68	56.1
69	53.6
70	51.2

Source: See Figure 5, author's calculations.

Economists have also considered the so-called effective dependency ratio, which is the ratio of economically active workers to inactive persons, where activity is defined in relation to paid work. The effective dependency ratio recognises that not everyone of working age (15-64 or however defined) are actually producing. There are many people in this age group who are also "dependent". For example, full-time students, house parents, sick or disabled, the hidden unemployed, and early retirees fit this description. We might also include the unemployed and the underemployed in this category although the statistician counts them as being economically active.

The effective dependency ratio is typically above the standard measure and emphasises the need to maintain a policy framework that sustains low rates of unemployment and underemployment.

There are three broad ways a government can address the challenges faced by rising dependency ratios:

1. Lower the sustained rate of unemployment and aim to have all willing workers engaged in productive employment.
2. Increase the productivity of workers through better public education; more integrated training programs (within a paid-work context); better investment in public infrastructure and investing in public health to improve standards.
3. Ensuring workers are productive for longer – relaxing restrictions on retirement.

The greatest gains come from a mix of these strategies but maintaining full employment is essential and should not be sacrificed in the pursuit of higher productivity.

At the federal level, the rising dependency ratio presents a political problem. The popular perception, promoted by some economists is that a rising dependency ratio is important because there will be a reduced tax base and hence increasing demands on the fiscal position. The fact is that it is not a financial crisis that beckons for the Federal government but a real one. Are we really saying that there will not be enough real resources available to provide aged-care or first-class hospitals at an increasing level? As long as these real resources are available then the federal government (as the currency issuer) will be able to provide them. The problem it faces is achieving a political mandate to do so when there will be competing claims – from younger generations – on the resources.

The problem is different at the State level given that governments are constrained both by the revenue and borrowing they can sustain and the available real resources. The goal of the state government should be to provide an adequate scope and quality of public services, which by their very nature require a motivated and well-trained staff.

Cutting the quality, scope and volume of services in a bid to save money is a myopic, self-defeating strategy. Productivity growth will be the key to balancing the resource demands and unbridled cost cutting approaches to efficiency rarely are effective.

7. The adequacy of public services

Cook, Quirk and Mitchell (2012) traced the development of state government policies in Australia over the past few decades. They demonstrated that governments have predominantly pursued policies that fit within the rubric of neo-liberal policies that privilege a concept of "fiscal responsibility", which involves providing funding and staffing resources for core services and withdrawing from non-core areas, and a shift from "rowing to steering" through the transfer of functions to the private sector through privatisation, PPPs and outsourcing.

The adoption and promotion of New Public Management has also impacted on public sector organisations through major policy changes such as: National Competition Policy; corporatisation of, competitive tendering and contracting out; organisational change such as policy-provider splits; and workplace reform at both the federal and state level that has changed the balance of power between governments and public sector employees (Hoque and Adams, 2008; Cook, 2006; Cook *et al*., 2008).

These are all tied in with the surplus budget narrative and it is clear that governments in Australia have not conducted coherent and robust impact evaluations of these policy changes in terms of their consequences for public service delivery. There is a sense that the surplus rhetoric is so powerful that reasonable policy evaluation is abandoned.

Cook, Quirk and Mitchell (2012) was the first major Australian study to attempt to document the impact of these policies on the delivery of a range of services by state governments in Australia and to assess the adequacy of services in terms of access, equity, the quantity and quality of services. As they demonstrated it is a difficult undertaking due to the complexity of service delivery, the lack of objective measures of the quality of services, and differences between jurisdictions in both the composition of services and data definitions.

Further, comprehensive data is not readily available to determine the parameters of service delivery and variations across space, which impact on access and equity. The transfer of aspects of service delivery to the private sector (both for-profit and not-for-profit) introduces further complications regarding variations in the standard of services and less transparency due to commercial arrangements, which are frequently not publicly disclosed.

Cook, Quirk and Mitchell (2012) used a fiscal retrenchment framework along the lines outlined in Section 2 of this Report to facilitate an understanding of specific policy developments in relation to improvements/deterioration of services. Within this framework, retrenchment strategies include:

- Programmatic retrenchment: imposing spending cuts and reshaping programs; and
- Systemic retrenchment: defunding the welfare state, undermining public support, and modifying institutions

There are a number of impediments to the retrenchment of services. First, widespread public support poses political risks (Pierson, 1994; Mishra, 1984). Secondly, powerful interest groups, including service users and public servants, are capable of mounting organised resistance to retrenchment policies. Breaking the power of groups who support the welfare state is considered essential for successful retrenchment (Pierson, 1994; Giddens, 1998). Viewed in this light, successful privatisation policies not only return functions to the private sector but also destroy organised opposition by public sector workers, thus making further retrenchment possible (Ferrera and Rhodes, 2000). Policy legacies, such as the perception of entitlements and expectations of future benefits, constitute the third factor restricting possibilities for successful retrenchment.

To overcome these obstacles, governments attempt to mask the true nature of reforms by making it difficult for the public to indentify connections between policy changes and adverse consequences. Successful techniques may include freezing spending in an environment of rising costs, altering indexation rules so that savings accrue automatically over time or incremental cuts to programs. Governments may offer compensation to those affected or implement “divide and conquer” tactics to reduce the possibility of organised opposition, by targeting changes to particular groups, or introducing means tests to split consumer groups.

There have been some major developments in Australia over the past few decades that have impacted on the delivery of services. These include: (1) the fiscal stance of governments that has determined the quantity of public spending within **self-imposed** and **arbitrary** budget constraints; (2) policy decisions on the relative priority of specific services; and (3) the commitment to transfer activities to the private sector through privatisation, PPPs and outsourcing.

Cook, Quirk and Mitchell (2012) concluded that there is a recurring pattern of inadequate provision due to public sector retrenchment and fiscal austerity is discernible across a wide spectrum of service areas. They conducted three in-depth case studies encompassing: (a) the state of child protection; (b) social housing and (c) biosecurity/primary industries research – each of which revealed a failure to invest in our nation’s future, a failure of governance and the abandonment of equity as a core policy principle.

The case study concerning biosecurity and primary industries research focused on Western Australia and revealed disturbing consequences of public sector funding and employment cuts. The recent developments relating to the Barnett Government, which were reported in that case study are reproduced in Appendix A of this Report.

Cook, Quirk and Mitchell (2012) noted the paucity of information governments provide as to the quantity and quality of service provision. In general there is a reliance on data collected by the government agencies themselves who, in turn, report on their own performance.

This becomes problematic. Although they report how long people are on elective surgery waiting lists, we are not told how long people had to wait to get on those lists. They may report how many unallocated child protection cases they have as of the 30th of June, but not how many were taken off the list on the 29th of June to hide the extent of their neglect. This highlights the crucial importance of preserving the independence and resources of auditors-general, and other scrutinising bodies, without whose reports the little that we do know of the state of public service provision would almost certainly remain hidden from public view.

Cook, Quirk and Mitchell (2012) also observed that while governments are aware of the suffering and neglect of the most vulnerable and disadvantaged Australians, be it due to their geographic location, the socio-economic status of their parents, or crises they have encountered in their lives, their race, disabilities that they were born with or have acquired, governments have applied insufficient resources to their care and inclusion.

Platitudes about building the 'fair-go' society, mouthed by political leaders to gain electoral support, are exposed for the hollow rhetoric they are where we see the poor waiting years with rotting teeth and gums, people needing help with basic daily care receiving little or none, individuals and families without secure shelter, children left in the hands of abusers, and State Treasurers hailing prison overcrowding as a good thing.

Our progress in building a decent, modern, civilised society, is not measured by the standard of living of the richest Australians, so frequently paraded before us, but by that of the poorest among us, of whom we hear so little. In the past thirty-five years of public sector retrenchment, social progress has been very slow and we are falling behind on many fronts.

In understaffed and ill-equipped health systems, we see inadequate degrees of access compromising the health of patients and severely impacting on the quality of their lives. People with mental illness are living in slum conditions, despite the neo-liberal promises of 25 years earlier that communities would be provided with the resources to care for them outside of institutional settings.

Hundreds of thousands of new dwellings are needed to meet the need for secure accommodation and redress the extent of homelessness, and they have not been built by reliance on the market alone. There needs to be a substantial increase in investment in public housing in every state of Australia.

After 35 years of public sector retrenchment we see little evidence that the supposed efficiencies, cuts to services, have freed resources in order that they be invested where they are most needed, as has been repeatedly claimed as the justification. We see cuts to services that needed more resources, and falling levels of public provision in so many areas, while wealth has accrued to the wealthiest, most politically powerful sectors of society.

We have underutilised our human and other productive resources across the country for decades, denying training and employment to hundreds of thousands of people who were available to provide these services, under the spurious assertion that it is efficient to do so, and left a trail of suffering and unrealised potential in our wake as a consequence.

Surely it is time for us to question the policy framework that has produced this result? Are we seriously saying we cannot afford to employ the people needed to provide these services? What real resource constraints are stopping Australians from providing even the poorest among us with the best standard of living in the world?

Appendix A – The Barnett Government and Biosecurity

The potential for the previous Labor Government's Biosecurity and Agriculture Management Act 2007 to facilitate further withdrawal of the government from primary industries research and biosecurity was not substantially advanced by the time of the election of Barnett Liberal Government in September 2008, but it provided a platform for subsequent wholesale abandonment of government responsibility in this crucial public policy area.

Whereas as Opposition spokesperson, Terry Redman expressed his concern in 2005 that:

> The level of funding towards the control of declared plants has dropped approximately 40 per cent over the past 10 years. We should not underestimate the impact of biosecurity breaches on agriculture. The amount of transport in and out of the state and imported products have the potential to introduce diseases from overseas (WA Legislative Assembly, 21/6/2005:3098 – 3134).

As Minister he has presided over the most significant functional and staff cuts of the decade, a clear withdrawal of governance, which informed observers consider will have dire implications for future generations.

This is despite the clear urging of the 2008 Beale review on biosecurity for the states to avoid reducing their capability in this area, given the damage resulting from previous under-investment, the rising threat of invasive species and diseases, and the certain knowledge that Australia's international competitiveness in agriculture will be significantly damaged if we fail to protect it (Beale, *et. al*, 2008).

In his account of changes to the department through the 1980s and 1990s, Noel Fitzpatrick notes the frequency with which incoming Ministers and Directors General declared the department was to embrace a supposedly new emphasis on supporting industry and economic development.

Given that the department had always existed to support the productivity and profitability of agricultural industries, he expresses some confusion as to what, precisely, was ever new about this repeatedly restated objective (Fitzpatrick, 2011).

The present Minister has in a sense, continued this tradition, explaining in May 2009 that:

> … agriculture deserves a better direction than the direction it has had in the past': it is to become an 'economic development agency.
>
> In developing that plan, we developed five key priorities, largely to redefine or re-centre the agency as an economic agency. Those five priority areas included plans to improve the long-term profitability; to develop an effective natural resource management policy; to build industry capacity to adapt and grow in the changing environment in which we find ourselves; to improve market access for Western Australian product; and to promote a positive profile for the WA food and agriculture sectors (WA Legislative Assembly, 26/ 5/ 2009: 136b-146).

In focus groups conducted by Cook, Quirk and Mitchell (2012), staff expressed confusion as to how this objective differs from that which the department had pursued in the past, and even more by its incongruence with what is actually happening on the ground (the italicised text report transcripts from the interviews).

They keep telling us that we're an economic development agency. And nobody can really tell us what that means. I get broadly supporting new agricultural industries, but they don't seem to care too much about the existing big agricultural industries that we've got. It's all about generating new investment and new industries... We always did that, they've just made that a larger role and basically the staff and resources have been cut back from biosecurity and the general work that we used to do (A6).

If agriculture 'deserves a better direction', farmers and the public in general might reasonably suppose this would entail making things better for the agricultural sector.

It has entailed deep staffing cuts according to the CPSU:

In recent years they've gone through a restructure that first started about 2 and half years ago. They changed their focus from being a research and development organisation and are now called an economic development organisation. So from that point of view the research seems to play a less important role. The other thing that has happened is there has been a reduction in staffing levels quite recently and that has an effect on the biosecurity staff as well. Officially they had 141 voluntary redundancies, last April (2011). If we actually look at the impact that's had, there's probably been another 193 if you include casuals and contracts as well...

But a lot of the experts have [...] been let go. Like the senior entomologist has been let go, the weather station expert they let go, the person who was the most expert on bees and bee research has gone (A3).

Experienced staff see the assumptions underpinning the new 'focus' of the departments as dangerously simplistic, particularly the assertion that private land managers will control the invasive species that economically impact on their operations, and if it does not impact on them, it doesn't matter.

They point to a fallacy of aggregation in the reasoning:

The farming industry itself will only deal with the pest that affects their bottom line. So, if there's a pest on a particular property, and it affects his bottom line, then he's going to control it. If the next door neighbour has got a slightly different farming system, and that particular pest doesn't impact on his economic bottom line, then he's not going to control it. So I think its more of a case of how that particular pest doesn't impact on that particular business, but impacts on the industry as a whole, and on the environment as a whole. See, you need to treat it as a whole, not - and this is the bottom line of the department - I suppose its saying in effect, if its economic then the industry will control it. But not every farming enterprise has the same business model. Different pests will impact on them all differently. So the cost benefit analysis has to be done as a whole not on an individual basis (A12).

The privatisation of governance over agriculture and biosecurity prepares the ground for big agribusiness to consume smaller operators, shifting the stewardship of Western Australian agriculture from people closely connected to the land and farming communities to distant, and often, foreign boardrooms

Where the department was once respected as a neutral source of advice, in preference to the company representatives that invariably pushed their product lines as the solution to every problem, the department is no longer there for them.

... farmers are always suspicious because, you know, particularly if Monsanto are out doing trials. What they used to like about the Ag Department was it's neutrality to issues. And now that everything goes to the private sector - not that I'm bagging the private sector - but you know the bottom line is that they've got an agenda to pursue and there's always that hint of doubt. And farmers are suspicious of, like, Monsanto with the GMO's, genetically modified organisms, now ... if you buy GM canola, you have to sign a contract saying that you will only use Monsanto chemicals and Monsanto fertilisers and bend over backwards for Monsanto, and you're only allowed to use their products. So they stitch you up every which way, its a condition of them supplying this particular seed.

[Do you think there is merit in that perception? Do you think that big agribusiness is favoured by the shifts that have happened in the Dept?]

Oh yes there is no doubt about it. We're going down the same way as America. It seems to be the way that privatisation - more and more of our culture now is industry funded by the private sector. I'd say probably 20% of our research staff are now funded by private industry... One of their barley breeding programs has just recently been sold to the private sector and is now being run by a private company, sort of in house... there's a little bit of a sharing opportunity with the Ag department [a reference to Intergrain Pty Ltd] (A4).

The government claims that it is taking a strategic decision to maximise the impact of it resources, by shifting away from farm inspections or direct responsibility for managing infestations that are substantially established, and increasing its border surveillance where its efforts have greater effect.

In reality it is simply shedding resources and running down the state's capability to manage the issue, as emerged in this exchange between politicians and officials at the May 2009 estimates hearings:

Mr D. Collopy (official)**:** The greatest benefit we can achieve from investing in biosecurity is at the end of the spectrum that deals with managing the risks of new, harmful organisms coming in and impacting on the state before those organisms get here or very shortly after they get here. Traditionally and in the past 20 years we have gradually moved resources largely from managing species that are widespread in the countryside to managing pests before they get into the state. For example, 15 years ago we made probably more than a thousand inspections a year of properties to enforce compliance with the control of Paterson's curse; whereas most of our investment now is in biological control. Because Paterson's curse occurs in over eight million hectares of the south west and on more than 7 000 properties, it is therefore no longer a pest that can be effectively managed by regulation; it has to be managed better by science and biological control. We have moved more resources into border biosecurity, thereby protecting ourselves at the border by preventing new organisms coming in, and also doing risk analysis to give us a better lead on what are the emerging risks and managing them before they get here. The member will therefore see a decline in the number of properties inspected, but the inspections that are made are far more targeted to the higher benefit end of the biosecurity continuum, rather than spending a lot of resources on managing pests that are already well established.

... Over the past 15 or 20 years [the department] has gradually migrated to a preventive focus through investing more in quarantine, border security and biosecurity. For instance, we did not have 24-hour checkpoints at Eucla and Kununurra 15 years ago; we now do. Those checkpoints are resourced by people who previously carried out on-farm inspections. Many of those pests are now very widespread, so our resources are going continually towards prevention.

Mr D.A. TEMPLEMAN: So we have given up!

Mr D. Collopy: No, we have not given up at all.

Mr D.A. TEMPLEMAN: That has occurred with locusts and starlings. Page 872 shows a reduction in animal pest programs for locusts and starlings. We have thrown in the towel!

Mr D.T. REDMAN: I might add that under the budget allocation of the former government the member's government in 2008-09 $16.6 million was allocated to the APB [biosecurity]; my government has allocated $16.677 million. The member referred to giving up resources; in this instance, there has been an increase.

Mr D.A. TEMPLEMAN: It is not a significant increase at all.

Mr D.T. REDMAN: In this environment, what sort of increase is the member expecting?

Mr D.A. TEMPLEMAN: I am expecting, if we are talking about international trade and all those associated issues and we are facing an increased risk from exotic pests being introduced into Western Australia, that our priority would be to increase what we are doing, both within the state and at our borders, to address these threats. The budget clearly shows that there has been no increase and, in fact, that the government is cutting back on a number of the programs that were being delivered in Western Australian agricultural regions

...

Mr D.T. REDMAN: The government is faced with a very different set of circumstances financially from a state perspective from what the previous government faced late last year. Even in those circumstances, this government has been able to maintain the level of funding in this division.

Mr D.A. TEMPLEMAN: But the department is losing 200 staff! (Legislative Assembly, 26/5/2009: 146-148).

Research staff have also been subject to cuts in pursuit of budget savings required to meet the government's three per cent 'efficiency dividend', despite the claimed focus on driving agricultural productivity.

A number of research programs were halted for 12 months in 2008-9, and staff reductions made as then Department Head Ian Longson attempted to explain:

In order to yield that efficiency dividend and look at moving staff to higher priority project areas under the government priorities, we are bringing about a reduction in the number of staff, and that is illustrated in the forward estimates further on in the papers. We are bringing down the staff numbers in the department from approximately 1 650 to 1 450. That will free up some

> operating money to address some of the higher priority areas. We have been able to achieve that reduction in staff, not by affecting permanent employees, but by not renewing contracts when they come up for renewal, and by reallocating staff to the high priority project areas. That process has gone on since January, and the numbers of full-time equivalents are shown in the forward estimates (WA Legislative Assembly, 26/5/2009: 146-148).

Longson's 5 years as Director General ended within days of this statement after discussion with the Minister 'having regard for the proposed future direction of the Department' according to Minister Redman (Redman, 2009).

A series of questions placed on notice in February 2011 revealed that so few as 50 FTE departmental staff were engaged in biosecurity surveillance, comprising 16 FTEs engaged in surveillance for plant biosecurity, 11 FTEs for livestock biosecurity and 23 FTEs for invasive species including European House Borer surveillance. It also confirmed the department had restructured its bio-surveillance functions so that they 'are now mainly industry-focused to facilitate [the] claim and maintain freedom from key pests and diseases' (Legislative Council, 15/2/2011:108), and that this restructure had resulted in a loss of positions.

Confirmation was also given that it had resulted in reduced surveillance of 'social insect pests' such as European wasps, and that out of a $38 million budget, only $6.5 million was dedicated to biosecurity surveillance across plant and livestock sectors (WA Legislative Council, 15/2/2011:108).

One practice the government has employed in recent years to minimise the political backlash for ongoing reductions in service is to create the illusion that it is still delivering services it has actually withdrawn, by ordering staff not to admit to the public that services are cut.

> *We've really been instructed by the department to not say that 'no we don't do that anymore'. It's just less staff doing the same job. So farmers aren't going to get the same level of service...*
>
> *The department would say nothing's been stopped. And every year they produce a list of, like, 'go to' people. So if you get a question about a particular issue, this is the person that you talk to. But regrettably, those people might be responsible for advice for 2 or 3 areas. Whereas previously they were an expert on one area*
>
> *[What are the consequences of that?]*
>
> *Increase in workload for staff that are here. A lot of our biosecurity officers are being forced to cover much bigger areas than they used to. A lot more travel and time away from home. There have been some office closures in the department, which has made it very hard for some areas to be serviced properly (A4)*

While the maintenance of a large website with images of field staff and researchers carrying out research, and contact numbers for information, etc., preserves the appearance of an extensive range of services, the hollowing out of the department has not gone entirely unnoticed.

In August 2011, for example, acting WA Farmers Wool Council President Ed Rogister vented his frustration at the lack of hands-on involvement of the department in regulating better sheep lice control practices, claiming the department had 'dropped the ball' since 1993, and that 'Mr Redman has decimated DAFWA' (Cattle, 2011). He said:

> We may as well not even have a department', he said. 'You only have to come into the Albany DAFWA office and see that there are corridors there with no lights on at all because all the employees have gone.
>
> The whole department from the Director General Rob Delane down needs to be changed. Mr Delane came out and said the department wanted to become an economic agency and he didn't want the department getting its hands dirty anymore. So what do we want an agriculture department for then? (Cattle, 2011)

Staff are mindful of the perception that successive reductions in staff and services have made their organisation irrelevant in the eyes of their principle client group, to the extent that farmers don't know what they actually do anymore. They're also demoralised with the inability of doing their jobs properly given the cuts they have sustained over years.

> *Go back 15 years ago, there was at least one officer in every single shire in the state. So now we've gone from that to one or two officers looking after half a dozen shires.*
>
> *So effectively what that means is that your surveillance for incursions of declared pests in a particular region is non-existent. We're reactive rather than proactive, so we don't actively go there and encourage people to be on the look-out for certain pests and diseases, give them information on that. Basically what we're doing is we're responding to a phone call (A12).*

This diminution in effectiveness of control weighs heavily on staff who know what was once considered manageable:

> *...[It's] Frustrating, because you go out there now and you can see small infestations, or infestations that are a declared species, that are quite small, and I'm talking plants here, and going back five or six years ago, and that were controlled, and we were preventing their spread. So you were having a positive outcome for the environment and for the industry as a whole. And you go out there now to those same areas and they've spread extraordinarily, because you can't facilitate proper control.*
>
> *By the time you get the control done its too late. You've got seed set, you've had a big rain event, water has run all the seed down the bloody road...(A12)*

Conclusion

The biosecurity threats facing Western Australia's $13 billion agricultural sector and its natural environment have been well understood by successive oppositions, governments and officials for decades and yet all have moved further away from addressing them, reflecting a complete abrogation of responsibility. No informed observer, certainly no one interviewed by Cook, Quirk and Mitchell (2012) considered the biosecurity arrangements of the past decade to have been adequate. Most insiders have raised the possibility of a large scale biosecurity threat, like the locust plague, and there not being enough people skilled and organised to deal with it.

Some interviewees expressed the view that the demise of the department stemmed in part from the electoral redistribution that established 'one vote one value' in the

Western Australia Legislative Assembly in time for the 2008 election, suggesting this has undermined the electoral significance of rural voters.

As we have seen, however, the progressive undermining of the Department's capacity to support rural industries, particularly the smaller farmer, has been underway far longer than this, arguably since the early 1980s. Fitzpatrick (2011) understood the sentiment to have first emerged from the federal sphere, that the state should not play the engaged and supporting role to farmers that it once did, that as commercial operators they should fend for themselves, and seek what advice and practical support they needed to remain viable, from private consultants in 'the market'.

This was a principle espoused by the Balderstone Report (1982), influenced by the submissions of the Productivity Commission's forerunner, the Industry Assistance Commission (IAC). This sentiment has been repeatedly expressed as the basis for withdrawing public services that would have enhanced the viability and security of Western Australian agricultural enterprises, regardless of the size of their operation.

The ideological principle at work here, a consequence of the 'new public management' and the spurious economics in which it is grounded, is that economies (and by extension, societies) work best when state intervention is minimal, and when markets are relied upon to regulate and coordinate people and their access to resources.

The heightened exposure to biological risks and the impact of poorly controlled invasive species on the sustainability and productivity of Western Australian agriculture, let alone the wholesale destruction of indigenous fauna and flora by human-introduced invasive species, is the legacy of dogmatic application of this ideology over the past 30 years.

While the private sector unquestionably has a role to play in meeting these challenges, the restoration of a large, capable, skilled and permanent biosecurity and primary industries research and extension workforce has to be seriously considered if these trends are to be reversed. Such a move would boost the productivity, marketability, viability, and profitability of Western Australia's agricultural businesses, large and small, and the regional and remote communities they support.

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