

Chapter 1: BUDGET POLICY AND POSITION

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1.1 BUDGET POLICY STATEMENT

BACKGROUND

The General Government Debt Elimination Act was passed by Parliament in late 1995. The Act provides, inter alia, for the Treasurer to prepare a Budget Policy Statement as part of each year's Budget Papers. The Statement is to include information on the following matters -

- an assessment of progress achieved against the fiscal targets and fiscal principles set out in the Act;
- projection of the ability to achieve fiscal targets in the future and to progress the achievement of fiscal principles; and
- 3-year projections of all relevant economic and financial variables.

This Section of Budget Paper No. 2 provides the Budget Policy Statement for the 1996-97 Budget.

ASSESSMENT OF PROGRESS ACHIEVED AGAINST THE FISCAL TARGETS AND FISCAL PRINCIPLES AND PROJECTED POSITION

Principle no. 1 - adherence to fiscal targets

- **Past Trends**

After achieving a surplus in 1988-89, the Budget result deteriorated rapidly as the economy slowed and the boom in the Sydney property market reversed. The deficit peaked in 1991-92 (refer to Table 1.7 in Section 1.2 for details).

- **Policy and Prospects**

The *short term fiscal target* is to achieve a sustainable Budget surplus for the general government sector within three years from the commencement of the Act.

The Budget and forward years' results projected in this Budget Paper show that the Budget is broadly in balance in 1996-97 with a modest \$5 million surplus and moderate surpluses in the following years.

However the Budget coverage at present is not based on the general government sector. The result for 1996-97 on a general government basis is also projected to be broadly in balance, as shown in Budget Paper No. 6.

Projections are not produced beyond the Budget year for the general government sector at this stage. However it is anticipated that on a general government basis, the result will be a surplus in 1997-98 and beyond.

It should also be noted that the Budget Sector results for 1996-97 to 1998-99 are inclusive of large expenditures on the Olympics and Homebush Bay development (\$442 million, \$605 million and \$387 million in the respective years). These years represent the peak years of Budget impact from these projects, confirming the prospect of continuing sustainable surpluses in following years.

The *medium term fiscal target* is to reduce the level of net debt to a sustainable level. This is defined as the level of net debt at which the Budget can absorb the full adverse impact of an economic cycle without the need for significant corrective action.

At present, the annual interest bill on Budget Sector debt is around \$1.6 billion. This consumes 7½ per cent of Budget receipts. Reducing debt and hence interest costs will decrease the exposure of the Budget to economic downturns and free resources for service provision and/or a lower tax burden. A comprehensive review is to be undertaken to determine the sustainable debt level.

The *long term fiscal target* is to eliminate net debt in the general government sector by 2020.

As part of the review of the sustainable debt level, work will also be undertaken to define a range of feasible time profiles for achieving the long term target.

Principle no. 2 - maintaining or increasing general government sector net worth

- **Past Trends**

General government sector net worth is defined as *total assets* less *total liabilities*.

As at 30 June 1995, the net worth of the Budget Sector was \$25.8 billion. The Public Accounts will present data as at June 1996 in October this year.

At present the Consolidated Financial Statements do not present information on the general government sector but it is likely to be broadly in line with the net worth of the Budget Sector.

Trends in the Budget Sector net worth are set out in Table 1.1.

Table 1.1: Trends in Budget Sector Net Worth

As at 30 June	Assets	Liabilities	Net Worth
	\$m	\$m	\$m
1991	58,195	30,718	27,447
1992	56,416 (a)	32,795	23,621
1993	57,685	35,155	22,530
1994	59,755	35,068	24,687
1995	61,742	35,985	25,757

(a) The decline between 1991 and 1992 is due to changes of coverage and valuation methodology, rather than an underlying deterioration.

- **Policy and Prospects**

The principle is to at least maintain the net worth of the general government sector in real terms. While information is not yet available on Budget Sector net worth as at June 1996 or the projected position as at June 1997, some tentative conclusions can be drawn.

In view of the projected balanced result for 1996-97, the \$3 billion capital program (which adds to the asset base) and the move to full funding of accruing superannuation liabilities, it can be assumed that Budget Sector (and by inference, general government sector) net worth will increase in real terms in 1996-97.

Similarly, given the projected Budget position for the forward years, this improving trend will continue.

Principle no. 3 - funding employer superannuation contributions

- **Past Trends**

Until 1992, the policy was to fund superannuation only on a *pay as you go* basis in respect of the employer liability. In 1992, the then Government introduced a new scheme, First State Super, which is an accumulation scheme for all new employees and is operated on a fully funded basis.

Trends in the level of unfunded superannuation liability for the Budget Sector are set out below in Table 1.2.

Table 1.2: Budget Sector Unfunded Superannuation Liability

As at 30 June	Budget Sector Unfunded Superannuation Liability
	\$m
1992	12,086
1993	12,422
1994	12,250
1995	12,687
1996	13,370

- **Policy and Prospects**

Debt is only a subset, although a very large subset, of total liabilities. Accordingly, it is important that the same policy of restraint that applies to debt applies to other non-debt liabilities.

Of the Budget Sector's non-debt liabilities of broadly \$17.9 billion as at 30 June 1995, the most significant component was the unfunded superannuation liabilities of \$12.7 billion.

This principle requires that -

- accruing superannuation liabilities (for both the general government and public trading enterprise sectors) should be fully funded; and
- there should be phased in funding to eliminate the existing level of unfunded liabilities.

In the absence of initiatives taken to bring unfunded superannuation liabilities under control, superannuation payments would consume an increasing proportion of Budget outlays and restrict the flexibility to cater for emerging social needs.

In accordance with the principle, this Budget continues the practice of fully funding each year's superannuation expenses in the First State Superannuation Scheme, phasing in full funding of other accruing superannuation liabilities and moving to address past unfunded liabilities. Based on latest actuarial assessments, while the accruing liability is funded to a substantial extent, it will not be fully funded on an ongoing basis until the year 2020. Similarly, the overall scheme will not be fully funded until the year 2045.

General government sector agencies currently outside the Budget Sector are also required to fully fund each new year's superannuation expense and where they have past unfunded liabilities, they are required to address these over a period, not exceeding 30 years (as from 1992).

Principle no. 4 - asset maintenance

- **Past Trends**

It is only in recent years that there has been a proper appreciation of the need to develop a formal asset maintenance policy. In the past such a policy was not in place due to the lack of adequate information on assets. This in turn resulted in a bias towards the acquisition of further assets at the expense of proper asset maintenance.

The introduction of accrual accounting in the Budget Sector has rectified the information deficiency.

- **Policy and Prospects**

Under the asset management policy, agencies are required to develop asset maintenance plans which identify all assets, set out a maintenance program for each asset or grouping of assets, identify any deferred maintenance requirements and establish a funding plan.

Asset maintenance plans will be required to be submitted in sufficient time to enable their review and approval by the Budget Committee of Cabinet prior to the 1997-98 Budget. The result of this process will be the endorsement of an asset maintenance program and the commitment by the Government of funding. It needs to be acknowledged that this will absorb some of the funding that may previously have gone into new capital projects. However, it is clearly inappropriate to expand the capital stock to the exclusion of adequate maintenance of existing assets.

Principle no. 5 - constrained growth in net cost of services and outlays

- **Past Trends**

Over the longer term, there has been a trend of significant real growth in Budget outlays. Over the two decades to 1994-95, New South Wales' own purpose outlays by the general government sector grew by 2.6 per cent per annum in real terms. This compares with a slightly lower growth rate of 2.3 per cent per annum for the six States combined.

- **Policy and Prospects**

The main strategy for achieving the objective of reducing debt and eliminating the Budget deficit is through restraint of Budget outlays.

The principle is to keep the growth in net cost of services and outlays below the growth in inflation and population (i.e. zero real growth in per capita terms). In respect of capital outlays, the principle is to be applied over a 3 to 5 year period to allow for the impact of large projects, such as the Olympics.

Budgets have traditionally reflected cash transactions, with outlays defined as cash payments less cash user charges.

The accrual presentation of the Budget includes non cash items such as depreciation, superannuation expenses, accounts receivable and accounts payable. This means that estimates are made up of expenses and revenues which are attributable to the current year's activities.

Accrual Budgets are able to reflect the *net cost of services*, i.e. total expenses less user charges.

Accordingly, the commitment to restraint of the net cost of services is an important extension of the policy of fiscal restraint.

In the 1996-97 Budget, current outlays are forecast to grow by 3.6 per cent. This represents a real per capita increase of 0.4 per cent (when measuring inflation on the basis of the non farm GDP deflator or a real per capita decrease of 0.9 per cent when inflation is measured by the CPI). Net cost of services is projected to increase by only 1.7 per cent in nominal terms, a real per capita decline of 0.2 per cent (based on the non farm GDP deflator or 1.5 per cent using the CPI).

Excluding the impact of the capital restructure payments from Non Budget Sector agencies, capital outlays will grow by 3.5 per cent in 1996-97 in nominal terms (including the near seven-fold increase in Olympics related expenditures). This represents a real per capita increase of 0.3 per cent. Capital outlays excluding both capital restructure payments and Olympics related expenditures will decline by 9.3 per cent in nominal terms.

Principle no. 6 - prudent risk management

- **Policy and Prospects**

There are risks that are centrally identified and managed and others that are the direct responsibility of individual agencies. Regardless of where the risk arises, it is vital that there is a comprehensive framework in place for identifying, assessing and addressing risk.

At the level of the whole general government sector, this involves seeking to reduce debt and other liabilities and to manage them in a prudent manner. Financial risks for the Budget Sector are centralised in the main, with Treasury Corporation managing total Budget Sector debt and relatively limited powers conferred on Budget Sector agencies for the management of financial assets.

As part of the process of developing Statements of Financial Performance, each Budget Sector agency will be required to identify and assess all financial and operating risks and develop strategies for dealing with these in a cost effective manner.

During 1995-96 Treasury Corporation was reviewed, with a view to eliminating all functions that involved undertaking a financial risk that was not essential for its core roles of funding and debt management. This has resulted in its elimination of various activities that added to the level of State risk and the elimination of broadly \$6 billion of surplus debt.

The principles applied to Treasury Corporation will be applied more generally to agencies during 1996-97.

Principle no. 7 - tax restraint

- **Past Trends**

Over the last recession and consequent deterioration in the Budget, there was substantial recourse to tax increases to keep the Budget deficit under control.

This experience was shared by most other States and as a result, while taxes in New South Wales increased in absolute terms, the tax burden relative to other States did not.

Over the period 1988-89 to 1994-95 inclusive, policy induced tax increases totalled \$980 million or, if expressed in 1995-96 prices, \$1,075 million.

Table 1.3: Trends in Tax Levels

Year	Policy Induced Tax Changes (a)	Index of Tax Burden in NSW relative to the National Average
	\$m	
1988-89	50	n.a.
1989-90	200	n.a.
1990-91	310	104.5
1991-92	80	104.0
1992-93	240	103.1
1993-94	100	101.6
1994-95	(-) 40	103.9
1995-96	10	n.a.
1996-97	(-) 20	n.a.

(a) Net effect of all tax changes impacting on the year shown, whether announced in that year or in previous years.

- **Policy and Prospects**

This principle requires that the level of taxes should be constrained to the maximum extent possible and that policies should be pursued that give a reasonable degree of predictability about the level and stability of tax rates for future years.

The Government recognises that the existing tax system is narrowly-based, generally regressive and relatively inefficient. New South Wales will continue to seek to achieve meaningful reform of Commonwealth-State financial relations in order to provide a more appropriate revenue structure for the State.

At the same time, it is important for taxpayers in the State to have a degree of certainty as to the level of taxes they will face in the future. The 1996-97 Budget, like the 1995-96 Budget, has achieved the financial targets set by the Government without recourse to tax rate increases. (In fact, as detailed in Chapter 3 of this Budget Paper, the refinancing of existing loans will be exempted from loan security duty as from 1 July 1996.) The intention is for future Budgets to maintain the position of no tax increases and, if possible and consistent with the overall fiscal targets, to achieve targeted tax relief.

It is also intended to seek over time to improve the structure of taxes in a revenue-neutral way. At present an intergovernmental review of financial taxes is underway to seek to achieve meaningful reform in this area.

In future every effort will be made to avoid further distorting the tax base. For example, increases in the tax threshold for payroll tax assist smaller firms but not, to any significant degree, medium and large sized firms. While the government has honoured the commitment of the previous government to increase the tax threshold for payroll tax from 1 January 1996, future tax relief is intended to be delivered by tax rate reduction rather than tax threshold increases or other sectional specific concessions.

ECONOMIC AND FINANCIAL VARIABLES

The following table sets out key economic and financial variables relevant to the Budget. More detailed data and discussion is contained in Section 1.2 (in relation to Budget aggregates) and in Chapter 2 (in relation to economic conditions and forecasts).

Table 1.4: Economic and Financial Variables

Variable	1995-96	1996-97	1997-98	1998-99
NSW GSP growth (%)	2.8	3.0	3.2	3.5
NSW employment growth (%)	3.0	1.3	2.0	2.0
NSW unemployment rate (%)	7.9	7.9	7.8	7.6
Sydney CPI (%)	5.0	3.3	2.8	2.5
10 Year bond rate (as at June) (%)	8.7	8.6	8.3	8.2
Budget result (underlying) (\$m)	(282)	5	155	167
Net Budget Sector debt (% of GSP)	7.9	7.5	7.1	6.7
Budget Sector debt costs (% of budget receipts)	7.7	7.0	7.2	6.6
Real growth in Budget Sector current outlays (%)	2.2	1.6	(-) 1.1	0.9
Real growth in Budget Sector capital outlays (a) (%)	16.1	1.5	1.8	(-) 8.0
Real growth in Budget Sector receipts (%)	4.2	3.0	(-) 0.1	(-) 0.3
Budget Sector employment (000)	229.4	230.1	n.a.	n.a.

(a) Excluding equity restructure payments.