

## CHAPTER 2: FISCAL STRATEGY AND OUTLOOK

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- ◆ The Government's medium-term fiscal strategy is designed to:
  - provide sustainable aggregate expenditure growth
  - maintain a competitive tax regime that is conducive to business investment and
  - maintain net debt and other financial liabilities at sustainable levels.
- ◆ The 2008-09 Budget delivers over the next four years surpluses averaging \$654 million, taxation reductions totalling \$2.2 billion and expense and revenue growth in alignment.
- ◆ General government net debt will increase by \$2.8 billion over the next four years, rising to 1.7 per cent of GSP (\$7.8 billion) in 2011-12. This reflects the very large increase in general government capital spending in the four years to 2011-12.
- ◆ Total state sector net debt will also rise over the four years to 2011-12, reaching 9.1 per cent of GSP, driven principally by record growth in PTE capital spending.
- ◆ Net financial liabilities of the general government sector will be 8.5 per cent of GSP in 2010 and then decline to 8.0 per cent by 2012.
- ◆ The 2008-09 Budget will increase the long-term fiscal gap, with taxation policy changes the major contributor.

## 2.1 INTRODUCTION

The *Fiscal Responsibility Act 2005* sets out both medium-term and long-term fiscal targets and principles for budgeting in New South Wales. In addition, maintaining a Triple A credit rating is a priority of the State Plan (P5). It is within this legislative and government policy framework that the budget is set each year.

The budget estimates extend over the immediate four year time horizon. However, the medium-term nature of the fiscal strategy is important because there are fiscal pressures looming beyond this period – notably the economic and budgetary effects of an ageing population. These pressures need to be taken into account to ensure that key services being delivered today remain affordable over the medium term.

The Government's medium-term fiscal strategy is designed to:

- ◆ provide sustainable aggregate expenditure growth
- ◆ maintain a competitive tax regime that is conducive to business investment and
- ◆ maintain net debt and other financial liabilities at sustainable levels.

## 2.2 FISCAL STRATEGY

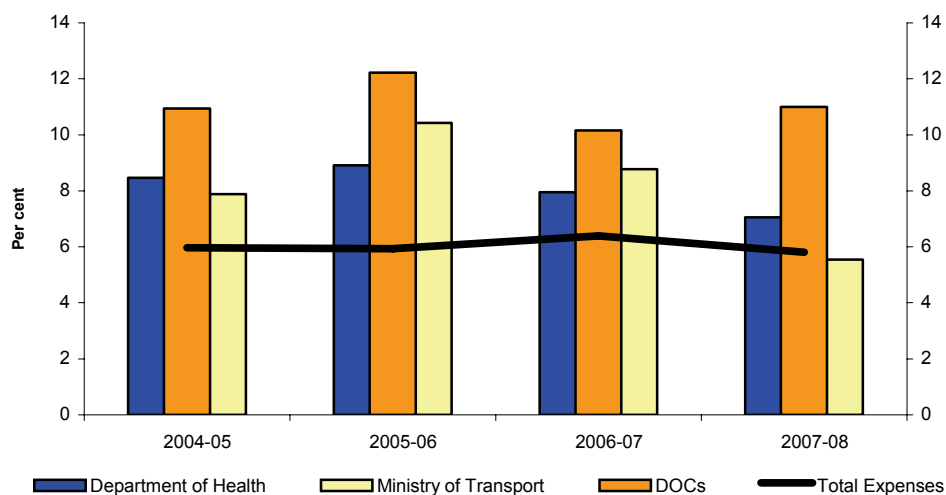
The Government's fiscal policy is medium-term in its focus and emphasises fiscal sustainability and a strong balance sheet. The objective is to maintain the State's finances in such a condition that they can support a consistent growth in services through time in the face of any economic and fiscal shocks that may arise. For example, expenditure decisions made in times of strong revenue growth need to remain affordable in times of weaker revenue growth. A key focus of the fiscal strategy, therefore, is to align the growth rate of expenses with the growth rate of revenues that will be sustainable in the long run. A strong balance sheet can absorb short-term differences in timing between expenses and revenues, such as the effects of weaker cyclical revenues. A strong balance sheet can also provide time for structural adjustment to increases in expenses and capital spending or lower revenues.

The balance sheet is now considerably stronger than it was in the mid-1990s, which puts the State in a much better position to handle both unexpected developments and the pressures that can be reasonably anticipated to emerge over the medium-term. However, the Budget has come under pressure in recent years, with strong growth in expenses in key areas such as health, transport, community services and police and justice, and a substantial increase in capital expenditure.

As capital expenditure has to be funded from operating surpluses, asset sales or borrowing, there are tensions between increases in the level of capital expenditure and operating expenses. For any given balance sheet constraint, increased expenditure on capital needs to be weighed up in terms of expenditure foregone on other services. The State's fiscal strategy is designed to manage the balance between spending on capital and operating expenses in a way that does not present a potential threat to the State's Triple A credit rating.

Chart 2.1 illustrates how expense growth in some key policy areas has been consistently exceeding overall expense growth. Spending on health, which accounts for over a quarter of the total NSW Budget, has risen substantially, growing by an average of 7 per cent a year over the four years to 2007-08 as the Government met its commitment to increase public access to quality health care. Public transport spending has increased by around 5.5 per cent a year over the four years to 2007-08 – in line with total expenses – and is expected to increase sharply over the coming four years, reflecting increased financial support for bus reform and rail services. Spending by the Department of Community Services has increased by an average of 11 per cent a year in the four years to 2007-08 as the Government dealt with a significant increase in child protection reports.

**Chart 2.1: Selected agency expense growth rates – four year average**



The Government responded to these increased spending pressures by introducing efficiency dividends, implementing a wages policy that will limit the cost of future wage increases to 2.5 per cent and delivering State Plan priorities within a budget-neutral framework. Notwithstanding these efforts, fiscal pressures will continue to mount with ongoing expenditure pressures, particularly in transport, and medium-term tax competition pressures requiring tax reductions to ensure New South Wales remains competitive with other jurisdictions.

Looking forward, expense pressures are set to intensify with the fiscal impact of the ageing of the population strengthening in the period beyond the forward estimates, with the population aged 65 and over increasing at double recent rates from 2011. The existing trend for health care costs to grow faster than the economy and revenues is expected to intensify thereafter, and the demand for improvements in the level of government services will grow as living standards continue to rise.

In addition, a slow down in the growth in the working age population, and consequently employment and gross state product (GSP) growth, can be expected to slow the growth of revenues. The combined effects of these anticipated trends in expenses and revenues will place the budget under pressure. It also brings into sharp focus the current and prospective expenditure and revenue responsibilities of the Commonwealth and the States/Territories. Current structural arrangements are unsustainable in the long run.

A significant factor in the fiscal outlook is the Government's infrastructure program, to be detailed in the 10 year *State Infrastructure Strategy (SIS)*. Total infrastructure spending over the four years to 2007-08 increased by 47 per cent, and is set to increase by a further 58 per cent over the four years to 2011-12. Public trading enterprise (PTE) sector spending is forecast to increase by more than 80 per cent and general government sector spending by 30 per cent. Beyond the forward estimates the capital program includes high levels of expenditure on the planned North West Metro and other rail network investments. Non-commercial PTE capital spending (principally rail), and general government capital spending, both need to be funded through budget surpluses and/or higher debt.

The Government has developed new budget processes to provide greater scrutiny and risk management of the capital program. These processes provide a whole-of-government planning and prioritisation of infrastructure plans over a medium-term (10 year) time horizon. They incorporate a new *Infrastructure Review* that considers agencies' 10 year Total Asset Management (TAM) plans within projected funding limits and allows the Government to consider major upcoming infrastructure priorities and risks early in the planning process. The results of the Infrastructure Review then feed into the annual budget process to provide a medium-term planning and fiscal context for considering final project funding approvals.

The new SIS budget process thus provides a link between long-term planning strategies and final project approvals, and assists Treasury, service-delivery agencies and the Government through a clearer understanding of infrastructure needs and funding constraints over the medium term.

A significant decision impacting upon the State's medium-term capital requirements was the Government's announcement last year to sell electricity retail assets and lease existing electricity generators to private operators, while keeping them in public ownership. The private sector is well placed to make the required future investment in electricity and would help ensure that electricity supply and reliability keeps pace with growing demand.

Creating the conditions for the private sector to make the investment in baseload capacity means that the government will not have to fund up to \$15 billion in investment in electricity requirements as the private sector will make the necessary investment. Therefore the Government will be able to focus its infrastructure budget in other areas (roads, trains, hospitals, schools and other essential infrastructure), where only the public sector is in a position to undertake the investment. If the Government were to fund the electricity investment in order to keep electricity supply secure, it would have to reprioritise the existing capital program that is set out in this Budget.

The Government's fiscal management strategy is built around controlling the growth in expenses over time, keeping the budget in surplus and maintaining a strong balance sheet. The *Fiscal Responsibility Act 2005* contains a number of benchmarks for balance sheet and operating performance which are designed to help achieve stronger fiscal outcomes for the State. Performance against all targets and principles is covered in detail at Appendix A.

General government net debt will remain above the target due to the large capital program, and will stabilise at a sustainable 1.7 per cent of GSP. The higher level of net debt will also see net financial liabilities remain above the 2010 fiscal target. Previous offsetting factors, such as falling unfunded superannuation liabilities as a share of GSP, were unwound over 2007-08 because of cyclical financial market developments. Weak investment returns during the year resulted in lower financial asset values which contributed to higher unfunded superannuation liabilities. General government net debt and net financial liabilities will, however, be considerably lower as a share of GSP than mid-1990s levels (see Charts 2.7 and 2.8). The operating statement principles are designed to constrain the growth in expenses, keep the budget in surplus and therefore help to limit the build up in liabilities. The target of fully funding general government superannuation liabilities by 2030 remains on track.

The Fiscal Responsibility Act targets are primarily directed at the general government sector because that is where services are generally provided free of charge or at a subsidised cost to the user. The cost of providing the services is met either directly from taxpayer revenues, or through additional borrowings, which ultimately have to be repaid by taxpayers. That said, the fiscal strategy does take into account the financial position of the State sector in total, because non-commercial PTEs receive support from the Budget through grants and subsidies and because the State's credit rating is determined by the level of total state net debt and net financial liabilities.

Maintaining a Triple A credit rating is a high priority for the Government, as reflected in the State Plan (priority P5). The highest credit rating provides a sign that the State's balance sheet is strong and sustainable and that service delivery growth can be maintained. The level of the rating is important because it influences the interest rate at which the State can borrow. The higher the rating, the lower are interest costs for a given level of debt. Lower interest costs in turn mean that more of the State's revenue can be used to provide services. Perhaps even more important is the influence that a high credit rating has on business confidence and, through that, business investment and employment in the State's economy. Ratings agencies have recently and repeatedly endorsed the Government's fiscal strategy.

## **2.3 2008-09 BUDGET**

Despite the significant challenges evident in a number of policy areas the expense and revenue plans in the 2008-09 Budget are consistent with the medium-term fiscal strategy in that overall aggregate expense growth rates are projected to be kept broadly in alignment with revenue growth rates. The budget surplus is expected to stabilise at modest levels and net debt as a share of the economy is also forecast to stabilise at low levels.

The operating result is projected to be in surplus over the next four years at an average of \$654 million, which is stronger than last year's budget estimates (recast on the new harmonised accounting standard basis). The net lending deficits will be higher than last year because of a larger general government capital expenditure program.

The level of net debt as a share of GSP is expected to be broadly the same over the forward estimates as was expected last year, stabilising at 1.7 per cent of GSP (compared to 1.8 per cent last year). Net financial liabilities are expected to be one percentage point above the target of 7.5 per cent in 2010, which is about 0.7 percentage points higher than was expected last year. This is largely because the downturn in financial markets during 2007-08 (commentary on financial market conditions is provided in chapter 9) lowered asset values resulting in a higher recorded level of unfunded superannuation liabilities. Importantly, net financial liabilities will continue to track lower beyond 2010.

## **2.4 BUDGET TRENDS**

### **EXPENSE TRENDS**

A key requirement for maintaining a sustainable fiscal position over the longer term is to align the growth of expenses with long-run average growth in revenue. While revenues can fluctuate significantly, expenses tend to rise consistently through time. Over the four years to 2006-07, expense growth exceeded revenue growth by around one percentage point per year. Measures have been taken to slow the growth in expenses, and these measures will continue to apply in the budget and forward estimates years, including:

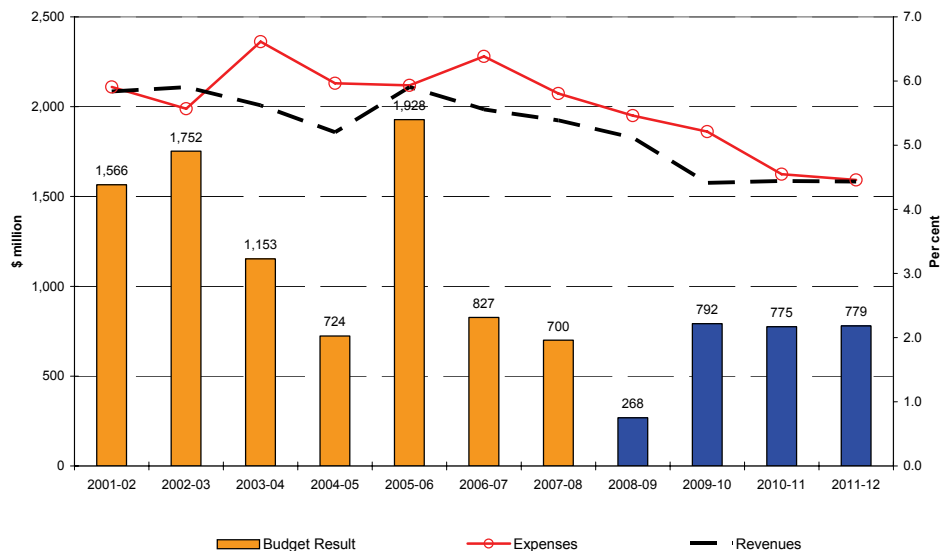
- ◆ a wages policy which seeks to moderate the growth in employee costs while maintaining the significant real wage gains made in key sectors and
- ◆ the ongoing application of efficiency dividends and productivity reforms.

Drivers of expense growth have been health, education, and transport, both because of the size of these portfolios relative to the general government sector and because they reflect the policy priorities of the Government.

Over the past three years, new budget processes, better budget management and achieving savings targets have seen underlying expense outcomes very close to original budget estimates. In 2007-08, abstracting from changes in "pass-through" funding from the Commonwealth for specific initiatives and the one-off repayment of rail debt, expenses will exceed the budget estimate by 0.6 per cent.

Expenses and revenues are both expected to grow by around 4½ per cent a year in the four years to 2011-12.

**Chart 2.2: Budget results and four year average expense and revenue growth**



The net operating result for 2008-09 and forward estimates reflects a number of offsetting factors, including:

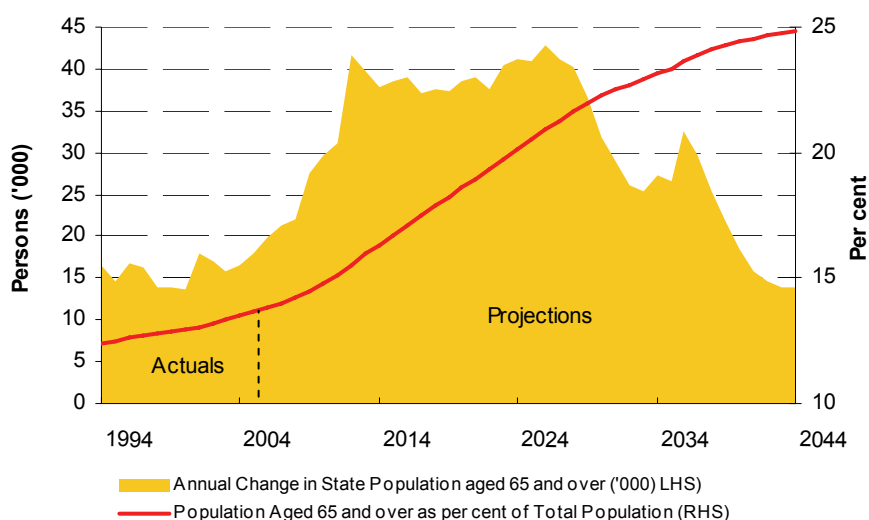
- ◆ tax reductions announced in this budget have lowered the revenue growth projections
- ◆ increased Commonwealth funding for specific COAG initiatives. This has increased the levels of both revenues and expenses, and has contributed significantly to the level of capital expenditure
- ◆ weaker financial market conditions over the past year have caused an increase in superannuation expenses in the forward estimates
- ◆ the opposing forces operating in the Australian economy, higher interest rates and the continued boom in global commodity prices, is reflected in cyclically lower growth in property and payroll tax revenues and lower growth in GST payments, partially offset by higher mining royalty payments and

- ◆ an increase in the level of expenses from increased capital grant funding for the North West Metro and South West Rail Link rail programs. This is recorded as an expense on the general government operating statement.

### Medium-term expense drivers

Beyond the forward estimates, the ageing of the population will bring more intense fiscal pressures. Chart 2.3 shows that the proportion of the population aged 65 years or more will almost double from 13.7 per cent in 2005 to 24.8 per cent in 2044. However, the fiscal and economic impacts of this demographic shift will be felt much sooner. The annual increase in this age group will more than double from 19,000 in 2005 to 40,000 in 2011 and remain at that elevated rate for the subsequent 20 years.

**Chart 2.3: Change of state population aged 65 and over**



*Source: 2006-07 NSW Budget Paper No.6 Long-Term Fiscal Pressures Report.*

Health expenditure has grown at an annual average rate of 7.5 per cent over the past five years. Rising costs, confronted by all health systems in all developed countries, are driven by:

- ◆ increased presentations at hospital emergency departments of patients with chronic and complex conditions or primary care needs
- ◆ increasing rates of obesity, diabetes and other lifestyle related illnesses
- ◆ a growing and ageing population

- ◆ changes in health technology including the availability of new and more advanced procedures
- ◆ rising community expectations and
- ◆ worldwide skill shortages for clinical staff.

Expense pressures in transport over the medium term are being driven by the ongoing growth of Sydney as a global city. Progressively more expensive transport infrastructure has to be fitted into the existing urban landscape (e.g. providing underground roadways and tunnels and metro style underground rail systems). The growth of Sydney will continue to present challenges in the area of urban congestion, and in the provision of public transport. This includes rising operating costs for public transport and increased construction costs for public transport infrastructure.

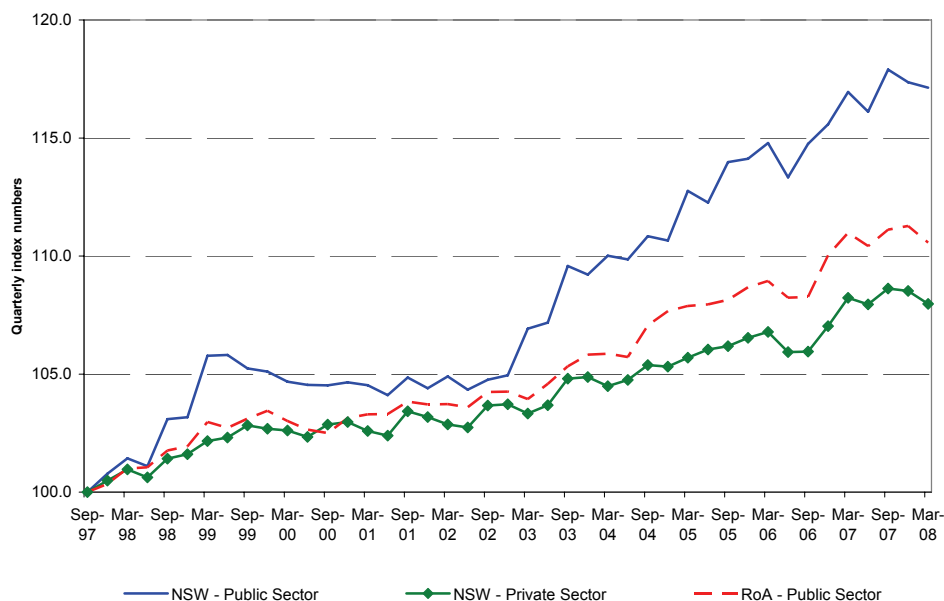
Education expenditure has grown by an average rate of 5.3 per cent over the past four years. This reflects a shift in the proportion of students in government and non-government schools as well as various education initiatives, which have led to expenditure per student rising over that period. Looking forward, student numbers are forecast to decline slightly in the short term, but then increase gradually in the medium to longer term. This, combined with demands for greater use of technology and increasing costs of educating students with special needs, will add to cost pressures.

The COAG reform agenda is a key medium-term response to future demographic pressures. The commencement of preventative health programs and early childhood education programs today will help to increase productivity and participation in coming generations. In turn this will lift economic growth and help to limit any slippage in the State's fiscal position. However, the cost of these programs needs to be met upfront while the benefits accrue over a considerable length of time.

## **WAGES POLICY**

Restraining growth in employee expenses, particularly wages, is critical to overall budget results because employee expenses account for nearly half of total expenses. This is true in the short run and in the long run because wage increases become embedded in the cost base and any extraordinary increases represent a structural weakening of the budget position which would require a commensurate structural change in revenues or other expenses.

**Chart 2.4: Real wage growth**



Source: ABS 6345.0, Labour Price Index, ABS 6401.0, CPI and NSW Treasury estimates.

Over the last decade NSW public sector employees have experienced wage increases well in excess of both inflation and those of employees in the NSW private sector and the public sector in the rest of Australia (refer Chart 2.4). The Government’s wages policy is to maintain the real value of these significant wage increases over time. The Government will fund wage increases and associated costs at 2.5 per cent per year, the mid-point of the Reserve Bank of Australia’s (RBA) 2–3 per cent target inflation range<sup>1</sup>. The policy permits wage outcomes in excess of 2.5 per cent, but only where the additional expense is offset by employee-related cost savings. This policy will assist in containing total expense growth.

The RBA actively pursues monetary policy to achieve its 2–3 per cent target inflation range. While inflation may fall below or rise above this target level, as is the recent experience, the RBA has a Charter with the Australian Government to keep consumer price inflation between 2–3 per cent on average over the cycle. Moreover, over the last decade or more, the RBA has achieved this target on average.

<sup>1</sup> Growth in employee related costs will also reflect other factors, including importantly changes in the numbers employed. Refer Chapter 3, p. 3-8.

While current forecasts put the expected level of inflation above 2.5 per cent for at least the next year, the Government is not proposing to increase the indexation factor. To do so would require lowering the indexation factor below 2.5 per cent in years where inflation is expected to fall below 2.5 per cent. While forecasts are not certain, what is certain is that the RBA will maintain its inflation target at 2.5 per cent. The RBA has also indicated that if higher inflation expectations were to be reflected in higher wage claims, the task of reducing inflation would be made more difficult.

The sensitivity of the budget result to wages and the modest levels of projected surpluses mean that if the wages policy is not strictly adhered to then the fiscal strategy will be under pressure. For example, if the cost of new wage agreements exceeds the 2.5 per cent target by one per cent per annum then employee-related expenses will increase by \$219 million in 2008-09, \$471 million in 2009-10 and \$1 billion in 2011-12, with clear consequences for the Budget position.

## REVENUE TRENDS

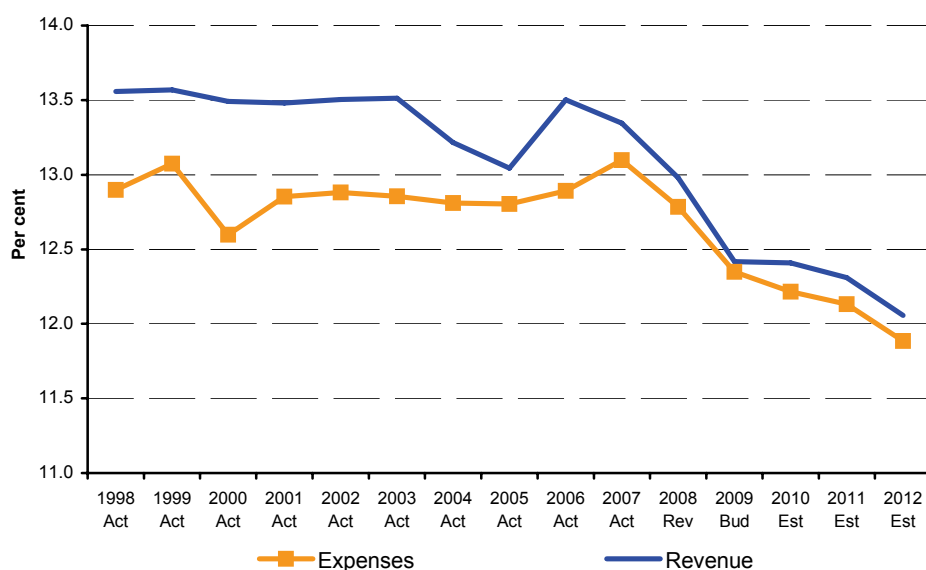
Revenue as a share of gross state product (GSP) is estimated to be around 1½ percentage points lower by the end of the forward estimates than it was in 1997-98 (refer Chart 2.5)<sup>2</sup>. This is influenced by taxation reductions undertaken by the Government since August 2005. The Government has taken a deliberate decision to reduce taxation where possible in order to support economic activity in the State.

The decline as a share of the economy also reflects the State's taxation base which, unlike the Commonwealth, does not benefit significantly from the recent and prospective large increase in commodity prices, but is substantially affected by higher interest rates. Demographic change will also impact on all of the main state revenues and on GST grants from the Commonwealth over the medium term.

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<sup>2</sup> *Expenses have also declined as a share of GSP, but by less than revenue, falling by around one percentage point over the same period*

**Chart 2.5: Total general government revenue and expenses as a share of GDP**



The 2008-09 Budget revenue estimates assume growth at slightly stronger rates (average 4.4 per cent) over the coming four years than was expected in the 2007-08 Budget (see Chapter 4 for detailed discussion of revenues). In contrast, nominal GDP is projected to grow by an average of 6.4 per cent over the next four years, boosted by the significant lift in the terms of trade in 2008-09. Expense and revenues as a share of the economy are therefore projected to continue to decline over the coming four years.

Revenues will benefit from an increase in the size of the GST pool lifting the level of GST grants paid to New South Wales, which reflects past growth in consumer spending. Mining royalty duties have been revised up substantially due to a doubling in coal contract prices. Commonwealth grants for roads and health have also been revised upwards, lifting overall revenue levels. However, higher interest rates will produce cyclically lower property market revenues and some slow down in the growth in payroll tax revenues, as well as slower discretionary income spending. Reductions in payroll tax rates and a bringing forward of the abolition of transfer duty on non-real business assets as announced in this Budget will also affect revenue growth.

Over the longer term the assumption is for revenue to increase by an average of 5 per cent per annum – which reflects historical growth patterns, adjusted for policy changes. While there are a range of risks surrounding any long-run projections, demographic changes represent a downside risk to a number of revenue components.

## Demographic change and revenues

Payroll tax revenue growth is related to the state of the labour market and has been growing more strongly than the economy in general. Over the four years to 2007-08 payroll tax revenue has been growing at 9 per cent per year compared to average nominal growth in the economy of around 6 per cent. It is reasonable to assume, however, that the growth of employment will slow in the future, and with it the growth in payroll tax revenue. One reason is that, abstracting from short-term cyclical influences, the unemployment rate has returned to historically low levels and the available pool of unemployed will cease to contribute to employment growth as it has over the last decade or more. With employment growth constrained due to ageing of the population, payroll tax revenue growth should slow, in line with slower economic growth.

Transfer duty on residential property is driven primarily by economic growth, mobility and house prices in the long term. The ageing of the population is likely to result in a decline in GSP growth (due to slower growth in labour supply) and in mobility, as older people are less likely to move. Countervailing this to some extent is the tendency for house prices to increase with wages rather than with inflation in general. Although the ageing effect will result in a decline in the rate of growth of this revenue, it may not necessarily decline as a share of GSP.

GST revenues are likely to grow more slowly than the economy over time, with health expenditure, which is not subject to the GST, assuming a larger proportion of consumer expenditure. This will mean slower growth in the overall size of the GST revenue pool.

Demographic changes rank as a common and significant factor in the preceding discussion of pressures that are likely to impact on both expenses and revenues over the medium term. They highlight the range and scale of the possible budget challenges that face state governments, and bring into sharp focus the importance of negotiating changes in financial relations between the Commonwealth and the States.

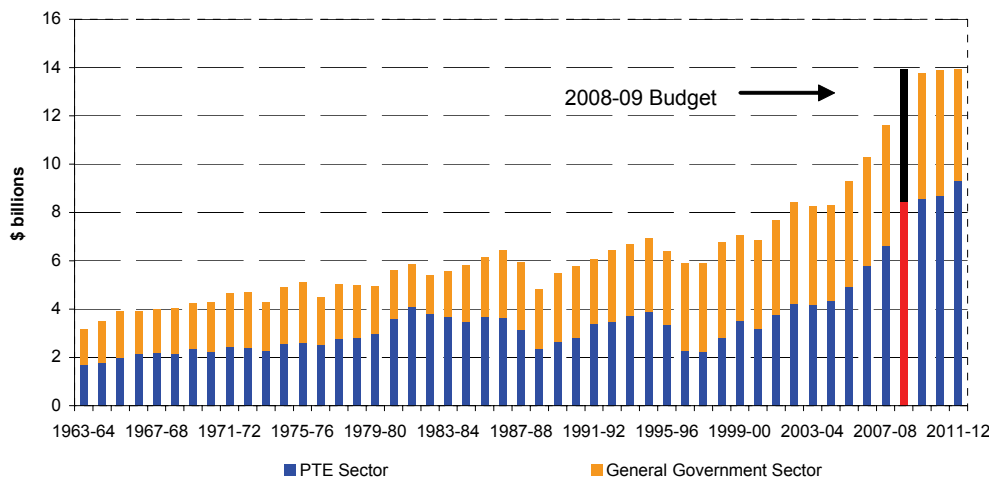
## 2.5 CAPITAL EXPENDITURE

The Government's capital expenditure program plays an integral role in delivering services to the people of New South Wales. The Government's 10 year program will be detailed in the *State Infrastructure Strategy* (SIS). The SIS links the four year budget cycle with the Government's metropolitan and regional planning strategies. This strategy delivers on the State Plan priority to maintain and invest in infrastructure (P2). The strategy importantly recognises the need to deliver the infrastructure program in a way that is fiscally sustainable.

The level of investment in infrastructure has grown significantly over the past decade, with total State infrastructure spending now more than double, in real terms, the average of the 1990s. The majority of the infrastructure investment and the source of most growth, was in the PTE sector, where levels are now more than two and a half times higher than the average of the 1990s in real terms. In the four years to 2008-09, the growth in total State infrastructure spending is estimated to average 13.9 per cent per annum in real terms. For the PTE sector that growth is 18.2 per cent a year in real terms.

Investment in the PTE sector (e.g. electricity, water and rail networks) tends to be driven by periodic requirements for major capacity expansions or replacement of assets that have reached the end of their economic life. Infrastructure trends in the general government sector on the other hand are smoother, with demand driven by the need to meet ongoing service delivery requirements in health, education and roads. Ultimately, however, all capital expenditure has to be funded from operating surpluses and borrowing, so the capital program has to comply with the Government's strategy for ensuring fiscal sustainability.

**Chart 2.6: State Capital Expenditure Program (2008-09 dollars)**



In 2007 the Government responded to recommendations in the report of the *Inquiry into Electricity Supply in New South Wales* (the Owen Inquiry) by committing to divest its electricity generation and retail assets. This will ensure continuity and reliability of electricity supply and avoid the Government having to fund up to \$15 billion in future investment in electricity requirements over the next 10 to 15 years. As noted in the report, there was a risk that if the Government financed the investment required, in addition to the large infrastructure program set out in this Budget, total State debt levels could approach proportions last experienced in the early 1990s, when the State was placed on credit watch by Moody's rating services for a possible credit rating downgrade.

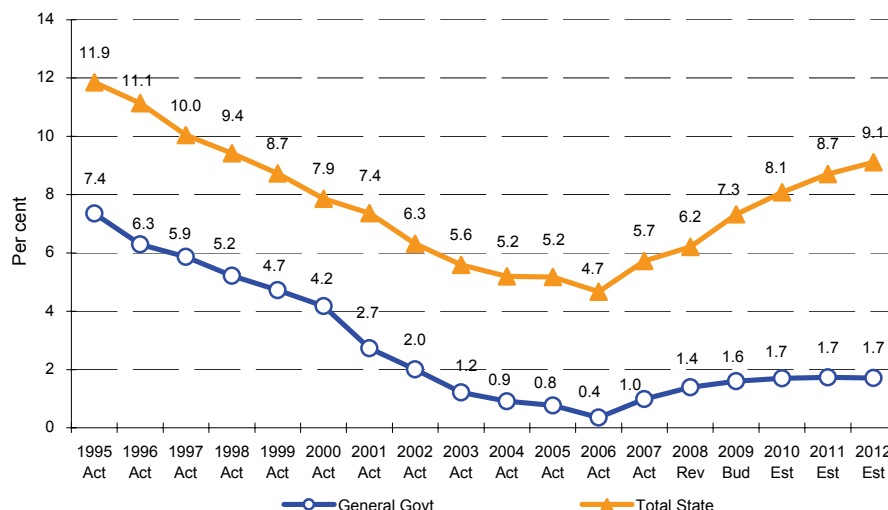
## **BALANCE SHEET**

### **Net debt**

Maintaining a strong balance sheet is a cornerstone of the Government's medium-term fiscal strategy, as it reflects the State's capacity to deliver and expand services in the future. Since the mid-1990s general government net debt as a share of GSP has declined significantly. Although it is projected to rise over the next four years to help fund a rapid acceleration in the level of infrastructure spending, it will remain at relatively low and sustainable levels. It is projected to stabilise at around 1.7 per cent of GSP, well below levels of the mid-1990s and below the levels projected last year.

Funding a rapid increase in infrastructure investment in the PTE sector is expected to cause total State net debt to increase substantially over the budget and forward estimates period. Total State net debt, therefore, after falling from around 12 per cent of GSP in 1995 to 4.7 per cent in 2006 is projected to rise to 9.1 per cent of GSP by 2012.

**Chart 2.7: Net debt as a percentage of gross state product<sup>(a)</sup>**



(a) Excluding the impacts of prepayment/deferral of superannuation contributions.

Source: NSW Treasury for net debt; ABS for GSP (actual) and NSW Treasury for estimates from 2006-07.

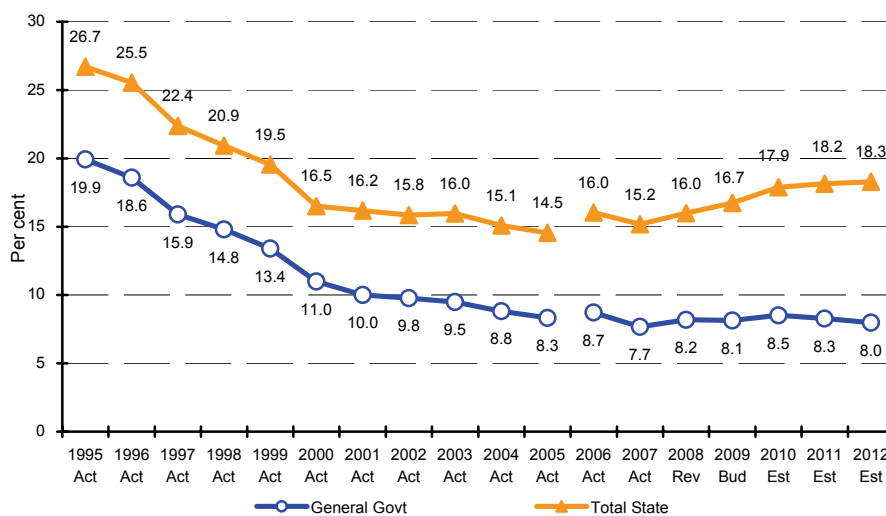
Beyond the forward estimates period the overall balance sheet position will depend on the balance between the size of budget surpluses and the strength of the capital spending program. Further increases in capital spending would require higher budget surpluses in order to slow the growth in net debt. Ratings agencies focus on total State net debt, its size relative to other comparable states, its rate of increase, and its composition (viewing PTE net debt as less creditworthy than general government net debt). Thus, even if all commercial PTE net debt were to be sustainably funded by regulated price increases, high levels of PTE net debt place constraints on general government net debt and, as a consequence, non-commercial capital spending for a given credit rating.

### Net financial liabilities

Net financial liabilities include net debt, unfunded superannuation liabilities, net self-insurance liabilities and other, primarily employee-related liabilities, such as long service leave. As a result of a concerted effort in this area, total State net financial liabilities have declined significantly as a share of GSP, nearly halving from 1995 to 2005. Over the budget and forward estimates period they are projected to increase, largely reflecting the partial debt funding of the significant increase in capital spending, particularly in the PTE sector, and will remain well below the unsustainable highs of the early to mid 1990s.

General government net financial liabilities are projected to be higher as a share of GSP than they were in last year's budget (0.7 percentage points in 2010) because of unfavourable movements in financial asset values during the course of 2007-08. Weaker financial markets during 2007-08 mean that the value of superannuation assets, for example, are lower than previously projected, leaving a larger measured unfunded superannuation liability on the State's balance sheet. Financial market volatility is a regular phenomenon and is to be expected (refer Chapter 9, p. 9-18). However, the fiscal targets were based on long-run average returns. While the measure of net financial liabilities recorded on the accrual accounting basis is at a higher level, more importantly the Government's cash contributions schedule to fully fund superannuation liabilities by 2030 remains on track.

**Chart 2.8: Net financial liabilities as a percentage of gross state product<sup>(a)</sup>**



(a) Series break in 2005-06 as a result of the adoption of Australian Equivalents to International Financial Reporting Standards. It has the effect of increasing the reported level of net financial liabilities.

Source: NSW Treasury for net financial liabilities; ABS for GSP (actual) and NSW Treasury (estimates from 2006-07).

## FISCAL TARGETS AND PRINCIPLES: PROGRESS

The Government reports every year in the budget papers on the progress achieved against the fiscal targets and principles that underlie the Government's fiscal strategy.

The fiscal target for the level of net debt in the general government sector is to keep net debt at or below its level as at 30 June 2005 (originally foreseen as one per cent of GSP, but subsequent revisions have lowered 2005 net debt to 0.8 per cent of GSP). Since the targets were set, the Government has significantly increased its program of infrastructure investment, which will be partly funded from increased borrowings. Net debt as a share of GSP, therefore, is forecast to be 0.9 percentage points above the fiscal target in 2010.

As a result, net financial liabilities as a share of GSP in the general government sector is forecast to be one percentage point above the medium-term target of 7.5 per cent by June 2010. Importantly, general government net financial liabilities as a share of GSP will decline thereafter.

The headline level of net debt and net financial liabilities will be significantly improved over the medium term as a result of the announced plans to transfer electricity retail and generation operations to the private sector. An underlying improvement in State finances will come from two sources:

- ◆ a lower risk profile associated with financial assets allocated to the Community Infrastructure (Intergenerational) Fund compared with dividends and tax equivalent revenues from the electricity businesses and
- ◆ the avoidance of additional capital expenditure associated with securing electricity supply. This will remove a significant threat to the State's credit rating as outlined in the report of the Owen Inquiry.

Although the recorded level of general government unfunded superannuation liabilities has increased since last budget, this is based on the Australian Accounting Standard AASB 119 (see Chapter 6 for further discussion). On a funding basis the long-term fiscal target in the Act to fully fund superannuation liabilities by 2030 remains on track.

Appendix A summarises the progress achieved against each of the fiscal targets and fiscal principles, and assesses the achievability of fiscal targets and principles in the future.

## Impact of 2008-09 Budget on the long-term fiscal gap

The 2006-07 Budget provided a benchmark estimate of the long-term fiscal pressures that New South Wales may face by comparing the actual budget outcomes for 2004-05 to the projected budget outcome for 2043-44. It was estimated that demographic and other pressures could lead to a fiscal gap<sup>3</sup> of around 3.4 per cent of GSP over the 40 year horizon.

One feature of the *Fiscal Responsibility Act 2005* is a requirement to report in every budget the long-term fiscal consequences of expenditure and revenue measures. As such, in addition to the usual budget reporting on the immediate effects of policy initiatives, the Government now provides an assessment as to whether policy changes will widen or narrow the long-term fiscal gap (as reported in 2006-07 Budget Paper No. 6 *Long-Term Fiscal Pressures Report*). This reporting considerably increases fiscal transparency.

The cumulative impact of changes introduced in the 2006-07 and 2007-08 Budgets was estimated to increase the fiscal gap to 3.5 per cent of GSP. New policy changes since the 2007-08 Budget, will increase the fiscal gap by 0.4 percentage points. The largest cause of the increased gap is tax reductions announced in this Budget, which account for 0.2 percentage points. A further 0.1 percentage points are attributed to the expense side of the budget, resulting from growth in demand for services in areas including health, transport and community services. The significant increase in capital expenditure plans contained in this Budget are also estimated to add around 0.1 percentage points to the fiscal gap.

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<sup>3</sup> *The fiscal gap is the difference between the base period primary balance as a share of GSP and the primary balance as a share of GSP at the end of the projection period, on a no policy change basis. The primary balance is the gap between spending and revenue excluding interest transactions but including net capital expenditure. A positive gap implies that fiscal pressures will be building over the projection period.*

**Table 2.1: Key fiscal indicators NSW 1997-98 to 2011-12 (per cent)**

	1997-98	1998-99	1999-00	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11	2011-12	
	Actual	Actual	Actual	Actual	Actual	Actual	Actual	Actual	Actual	Actual	Revised	Budget	Est	Est	Est	
<b>General Government Sector</b>																
Revenue/GSP	13.6	13.6	13.5	13.5	13.5	13.5	13.2	13.0	13.5	13.3	13.0	12.4	12.4	12.3	12.1	
Revenue Growth - Nominal	4.9	6.0	5.5	5.9	5.8	6.3	4.4	4.3	8.7	4.9	3.7	3.2	5.8	5.0	3.7	
Revenue Growth - Real <sup>(a)</sup>	3.6	5.6	3.3	1.5	3.4	3.3	0.1	0.5	3.7	0.3	(1.2)	(3.4)	3.3	2.5	1.2	
Tax Revenue/GSP	6.5	6.7	6.8	5.6	5.3	5.3	5.3	5.1	5.0	5.3	5.2	4.8	4.7	4.6	4.6	
Tax Revenue Growth - Nominal	10.0	9.4	7.6	(12.2)	(1.0)	7.1	6.2	2.0	3.8	11.3	4.3	0.4	3.6	4.4	4.4	
Tax Revenue Growth - Real <sup>(a)</sup>	8.6	9.0	5.3	(15.9)	(3.2)	4.1	1.8	(1.6)	(1.0)	6.4	(0.6)	(6.0)	1.1	1.8	1.9	
Expenses/GSP	12.9	13.1	12.6	12.9	12.9	12.9	12.8	12.8	12.9	13.1	12.8	12.3	12.2	12.1	11.9	
Expenses Growth - Nominal	3.0	7.4	2.3	8.2	5.9	6.0	6.4	5.6	5.7	7.9	4.1	4.2	4.7	5.2	3.7	
Expenses Growth - Real <sup>(a)</sup>	1.7	7.0	0.1	3.6	3.4	3.0	2.0	1.8	0.8	3.2	(0.8)	(2.4)	2.2	2.6	1.2	
Net Operating Result/GSP	0.7	0.5	0.9	0.6	0.6	0.7	0.4	0.2	0.6	0.2	0.2	0.1	0.2	0.2	0.2	
Net Operating Result /Revenue	4.9	3.6	6.6	4.6	4.6	4.9	3.1	1.8	4.5	1.8	1.5	0.6	1.6	1.5	1.4	
Gross Capital Expenditure/GSP	1.4	1.4	1.2	1.2	1.2	1.3	1.2	1.1	1.3	1.3	1.4	1.4	1.3	1.3	1.1	
Net Lending/GSP	(0.2)	(0.1)	0.6	0.2	0.2	0.2	0.0	(0.1)	0.1	(0.3)	(0.4)	(0.5)	(0.3)	(0.2)	(0.1)	
Net Lending/Revenue	(1.6)	(0.5)	4.4	1.6	1.7	1.3	0.1	(0.5)	1.0	(2.3)	(3.0)	(4.2)	(2.5)	(1.8)	(1.1)	
Net Debt/GSP <sup>(b)</sup>	5.2	4.7	4.2	2.7	2.0	1.2	0.9	0.8	0.4	1.0	1.4	1.6	1.7	1.7	1.7	
Net Debt/Revenue <sup>(b)</sup>	38.5	34.8	31.0	20.3	14.8	9.0	6.8	5.9	2.6	7.4	10.7	12.9	13.7	14.0	14.2	
Interest/Revenue	5.5	4.8	4.5	3.2	2.6	2.2	2.1	2.7	2.8	2.8	2.8	3.0	3.0	3.1	3.2	
Net Financial Liabilities/GSP	14.8	13.4	11.0	10.0	9.8	9.5	8.8	8.3	8.7	7.7	8.2	8.1	8.5	8.3	8.0	
Net Financial Liabilities/Revenue	109.0	99.1	81.4	73.8	72.3	70.6	66.7	63.7	64.6	57.4	63.1	65.4	68.7	67.3	66.2	
<b>Total State Sector</b>																
Net Operating Result/GSP	1.0	0.6	1.2	0.9	1.0	0.6	0.4	0.3	0.8	1.0	0.4	0.2	0.5	0.7	0.7	
Net Operating Result /Revenue	5.8	3.5	7.1	5.6	5.8	3.9	2.8	1.9	5.1	6.1	2.5	1.4	3.5	4.4	4.8	
Gross Capital Expenditure/GSP	2.2	2.4	2.4	2.3	2.4	2.5	2.4	2.3	2.7	2.9	3.2	3.6	3.5	3.4	3.3	
Net Lending/GSP	(0.0)	(0.3)	0.3	0.5	0.0	(0.3)	(0.3)	(0.5)	(0.4)	(0.5)	(1.3)	(2.0)	(1.4)	(1.2)	(1.1)	
Net Lending/Revenue	(0.2)	(1.9)	1.8	2.7	0.2	(1.6)	(2.2)	(3.3)	(2.2)	(3.3)	(8.3)	(12.9)	(9.2)	(8.1)	(7.5)	
Net Debt/GSP <sup>(b)</sup>	9.4	8.7	7.9	7.4	6.3	5.6	5.2	5.2	4.7	5.7	6.2	7.3	8.1	8.7	9.1	
Net Debt/Revenue <sup>(b)</sup>	55.7	52.3	46.5	44.0	38.3	34.1	32.5	32.7	28.9	35.6	39.4	48.0	53.1	57.5	61.2	
Interest/Revenue	7.0	5.6	5.2	4.8	3.8	3.7	3.7	4.3	4.3	3.7	4.5	4.9	5.4	6.0	6.4	
Net Financial Liabilities/GSP	20.9	19.5	16.5	16.2	15.8	16.0	15.1	14.5	16.0	15.2	16.0	16.7	17.9	18.2	18.3	
Net Financial Liabilities/Revenue	123.8	117.1	97.5	96.7	96.0	97.4	94.2	91.8	99.2	94.4	101.4	109.7	117.5	120.0	123.0	

(a) Deflated using the gross non-farm product deflator.

(b) Net debt excludes the impacts of prepayment/deferral of superannuation contributions.

**Table 2.2: Key fiscal indicators NSW 1997-98 to 2011-12 (\$m)**

	1997-98	1998-99	1999-00	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11	2011-12
	Actual	Actual	Actual	Actual	Actual	Actual	Actual	Actual	Actual	Actual	Revised	Budget	Est	Est	Est
<b>General Government Sector</b>															
Total Revenue	27,007	28,636	30,225	32,018	33,888	36,025	37,614	39,217	42,629	44,727	46,396	47,882	50,665	53,223	55,186
Tax Revenue	12,897	14,115	15,185	13,337	13,210	14,146	15,018	15,324	15,902	17,697	18,466	18,533	19,194	20,034	20,923
Total Expenses	25,683	27,595	28,222	30,531	32,322	34,273	36,461	38,483	40,701	43,900	45,696	47,614	49,873	52,448	54,407
Net Operating Result	1,314	1,041	2,003	1,487	1,566	1,752	1,153	724	1,928	827	700	268	792	775	779
Gross Capital Expenditure	2,761	3,002	2,733	2,859	3,102	3,349	3,331	3,331	3,949	4,272	4,865	5,477	5,352	5,475	4,976
Net Lending/Borrowing	(425)	(132)	1,322	525	573	461	41	(178)	431	(1,020)	(1,410)	(2,025)	(1,290)	(966)	(611)
Net Debt	10,389	9,967	9,355	6,486	5,026	3,232	2,576	2,320	1,114	3,308	4,978	6,191	6,922	7,467	7,809
Interest Expenses	1,490	1,363	1,348	1,021	868	803	789	1,061	1,184	1,257	1,297	1,440	1,540	1,666	1,773
Net Financial Liabilities	29,440	28,377	24,500	23,635	24,502	25,418	25,072	24,992	27,528	25,695	29,263	31,336	34,784	35,830	36,511
<b>Total State Sector</b>															
Total Revenue	33,698	35,237	37,910	39,758	41,410	43,690	45,510	47,629	51,072	53,895	56,391	58,869	62,189	65,409	68,095
Total Expenses	31,739	34,002	35,237	37,515	39,011	41,984	44,249	46,712	48,487	50,589	54,962	58,038	60,034	62,537	64,801
Net Operating Result	1,959	1,235	2,673	2,243	2,399	1,706	1,260	918	2,586	3,306	1,429	831	2,155	2,872	3,294
Gross Capital Expenditure	4,436	5,142	5,460	5,365	6,080	6,697	6,705	6,982	8,379	9,776	11,338	13,930	14,111	14,587	15,013
Net Lending/(Borrowing)	(57)	(675)	666	1,080	63	(698)	(984)	(1,577)	(1,145)	(1,774)	(4,691)	(7,591)	(5,724)	(5,302)	(5,083)
Net Debt	18,761	18,419	17,613	17,495	15,852	14,891	14,783	15,555	14,741	19,186	22,198	28,243	33,005	37,626	41,698
Interest Expenses	2,350	1,966	1,987	1,906	1,567	1,626	1,675	2,065	2,210	2,008	2,523	2,878	3,357	3,936	4,371
Net Financial Liabilities	41,705	41,259	36,959	38,452	39,769	42,562	42,881	43,705	50,664	50,893	57,164	64,567	73,045	78,471	83,749
Gross State Product (current prices)	199,205	211,060	224,039	237,520	250,944	266,582	284,605	300,636	315,709	335,144	357,422	385,607	408,278	432,329	457,760