CHAPTER 1: OVERVIEW OF STRATEGIC DIRECTION AND ENVIRONMENT

- The 2001-02 NSW Budget reduces the State's overall tax burden, targets the continuing provision of essential services and maintains the State's strong financial position.

- The Budget provides for a Budget surplus of $368 million in 2001-02, and projects further surpluses in each of the three years to 2004-05. Consistent with the Government's fiscal strategy, these surpluses will be used to reduce the General Government Sector's Net Financial Liabilities from an estimated $22,481 million at 30 June 2001 to $21,272 million by 30 June 2005. This follows the $6,456 million reduction in Net Financial Liabilities achieved over the four years to 30 June 2001.

- Through continuing to strengthen the balance sheet in this way, the Government is ensuring that the people of New South Wales are able to afford high quality services in 2001-02 and beyond. Expenditure priorities combine ongoing and new measures focused on key service delivery areas, including education, public transport, health, law and order, the environment and natural resources.

- Building on the tax reduction initiatives commenced in the 1999-2000 Budget, the rate of payroll tax will be reduced further from 6.2 percent to 6.0 percent from 1 July 2002 at a full year cost of $142 million.

- This Budget also introduces a package of tax measures that abolishes debits tax, suspends the electricity distributors levy, reduces lease duty and hiring arrangements duty, and abolishes duty on instruments relating to superannuation. The total full-year impact of new tax reduction measures in this Budget is $421 million. This is offset by the recently announced introduction of the Insurance Protection Tax to raise $69 million per year to help finance the Policyholders Protection Fund.

- Economic growth prospects in 2001-02 are expected to improve on 2000-01. The economic fundamentals in New South Wales remain strong. Economic growth is expected to average close to 3 percent per annum over the budget estimates period, and the State's employment is expected to continue to grow at an average rate of about 1 percent per annum.

1.1 REVIEW OF GOVERNMENT'S POLICY PRIORITIES

GOVERNMENT POLICY PRIORITIES

Expenditure patterns in the 2001-02 Budget reflect the Government's priority of adequately supporting both essential ongoing programs and important new initiatives, which are summarised in the remainder of this section. Chapter 4 provides further details on future priority measures in the 2001-02 Budget by policy area. Details of the programs to be undertaken by each General Government agency are contained in Budget Paper No 3 (*Budget Estimates*) and Budget Paper No 4 (*State Asset Acquisition Program*).

In line with the Government's overall economic and fiscal strategy, key policy priorities for the 2001-02 Budget are:

- ensuring that New South Wales remains the engine room of the Australian economy, including implementation of the *Beyond 2000* jobs strategy;
- recognising the requirements of rural and regional New South Wales by supporting these areas to fully realise their potential;
- building the foundations for strong, healthy and well-educated communities;
- achieving a sustainable natural environment through measures to address air and water quality, including initiatives to address the growing salinity problem;
- focusing on major transport initiatives which improve the safety and reliability of public transport services, including new rolling stock and infrastructure upgrading for rail; and upgrading of key segments of the road network to provide for fast-growing demand;
- creating a safer State through smarter policing, encouraging local solutions to crime, and continuing the battle against drug use;
- undertaking a program of major capital works to underpin the delivery of essential services including school education, health and public safety; and
- providing an industrial relations regime that appropriately balances the interests of employers and workers, recognising the need to support the competitiveness of NSW business while also making New South Wales an attractive State in which to live and work.

FINANCIAL PERFORMANCE

The NSW Budget is based on a strong commitment to responsible financial management. This commitment is essential to mitigate the shorter term fiscal risks to service delivery associated with fluctuations in economic conditions, and the risks from demographic and social pressures that are emerging over longer periods.

Keeping NSW finances strong helps to ensure that this and future Governments will be able to continue to address the growing demands for high quality public services. The key features of New South Wales' financial management strategy are legislated in the *General Government Debt Elimination Act 1995* and have been set out more expansively in previous years' Budget Papers.

New South Wales' strong economic performance has assisted the achievement of Budget cash surpluses in the last five years. These surpluses are striking in an historical context, only two surpluses having been achieved between 1961 and 1995 as shown in Chart 1.1 later in this chapter. These results were achieved at the same time that the Government implemented a comprehensive program of tax reductions and hosted the 2000 Olympics.

New South Wales retains a AAA credit rating. In reaffirming its AAA rating for New South Wales this year, the ratings agency Standard and Poors stated,

> "*Fiscal performance in recent years has been very strong with five consecutive public sector cash surpluses.....financing the Olympic Games within these budget surpluses was a major achievement*".

The soundness of NSW fiscal fundamentals holds the State in good stead at a time of uncertainty about the global economic outlook. While the most likely outcome is for economic growth to start to pick up over the next few quarters providing for a Budget surplus of $368 million in 2001-02, a more sober outcome can be accommodated without harsh policy reactions being required.

Section 1.2 provides further details on financial performance and progress against fiscal targets and principles underpinning the State's medium term fiscal strategy, while section 1.3 provides details on recent economic performance and the economic outlook for the forward estimates period.

A separate Budget Guide which accompanies these Budget Papers provides additional information on various Budget operating results and measures of the State's financial performance.

NEW SOUTH WALES REMAINS THE ENGINE ROOM OF THE AUSTRALIAN ECONOMY

The Government's key strategies to ensure that New South Wales remains the engine room of the Australian economy include:

Maintaining a good environment for business

- Continuing the implementation of a comprehensive tax reduction program commenced in the 1999-2000 Budget, which will help ensure that New South Wales remains a preferred destination for business investment. This Budget introduces further tax cuts and implements previous tax reduction commitments.

- As part of the measures announced in the 1999-2000 Budget, the payroll tax rate will be reduced from 6.2 percent to 6.0 percent from 1 July 2002 at a cost of $142 million in a full year.

- New tax reduction measures to benefit businesses in the 2001-02 Budget worth $421 million a year include the abolition of debits tax (provided that the Commonwealth agrees to New South Wales not being penalised under national tax reform arrangements) and duty on instruments relating to superannuation; the suspension of the electricity distributors levy; and greatly increased thresholds for lease duty and hiring arrangements duty.

- These measures are in addition to about $1,100 million worth of State taxes to be abolished from 1 July 2001 as part of the tax reform program agreed between the Commonwealth and States and Territories in 1999.

- Continuing reforms in the water, electricity and gas sectors to promote competition, complemented by the process of review and reform of anti-competitive legislation.

- Capitalising on the international exposure the 2000 Olympics gave New South Wales to promote the State as a modern, dynamic and high-technology economy as well as a highly attractive tourist destination.

- Maintaining the State's AAA credit rating, keeping debt at sustainable levels and maintaining a tax regime which provides reasonable predictability and stability of tax rates.

- Re-invigorating the public education system so that young people can take up the opportunities of a diverse economy through, among other things, a broad and responsive curriculum, new multi-campus arrangements, and integration of information technology into more aspects of teaching and learning.

Making it easier for business to deal with Government

As part of the initiative to further advance e-government, transactions between the private sector and the Government will be made easier through the investment of $79 million in a package of measures, including the following:

- Replacement of the current licensing system, where several Government agencies administer some 20 licences, with a single entry point for electronic licensing by all major agencies. This is expected to be completed by June 2003.

- A single internet point for lodging court documents electronically and land title related inquiries will be available by the end of the fiscal year, allowing the lodging of application forms, development applications, affidavits and expert reports. Court decisions on all criminal and some civil matters will also be available through the internet.

- Businesses will be able to submit their annual payroll tax returns over the internet from July 2001.

- Lawyers and conveyancers will be able to pay stamp duty for property purchases, mortgages and leases online by early 2002.

- Planning information on the industrial and commercial development of land in Newcastle, Wollongong and the Central Coast will become available online during the year, expanding the current service beyond Sydney.

Creating jobs, improving the workplace and minimising economic dislocation

- The Government will continue to implement, in partnership with the private sector, its *Beyond 2000* jobs strategy introduced in 1999-2000. The strategy aims to create 200,000 jobs by 2003, and includes construction, infrastructure and forestry projects worth over $25,000 million. The strategy contains a number of regional infrastructure projects representing more than $10,000 million in new investment for regional New South Wales.

- The Government is on track to achieve its jobs target. Between March 1999 and April 2001, employment in New South Wales increased by over 150,000. New capital works projects should sustain an average of 6,000 construction jobs each year for the next four years.

- The Government is committed to helping minimise economic dislocation during times of difficulty. Examples of this include:

  - One-off assistance to farmers and small businesses in flood-affected areas, including increases in low interest loans as well as lengthening the interest free period from one to two years for new loans. This will now be a permanent part of future responses to natural disasters.

  - New South Wales is currently working with other States and the Commonwealth to deal with the consequences of the collapse of HIH Insurance. Provision is made in the 2001-02 Budget for an additional $600 million in General Government expense in 2000-01, of which $50 million will be absorbed and the remainder funded by the recently announced introduction of an Insurance Protection Tax. Further details of the impact of HIH Insurance related measures on the NSW Budget and forward estimates are provided in Chapter 2.

- In the work place, the Government is pursuing a number of measures, including legislating a code of conduct for the clothing industry; amending the *Industrial Relations Act 1996* to allow the recovery of unpaid wages; retraining workers to improve job choices; and negotiating with the Commonwealth for a national scheme protecting workers' entitlements. A new public sector management and employment framework will be introduced to ensure the continued delivery of public services in the most efficient manner.

DEVELOPING RURAL AND REGIONAL NEW SOUTH WALES

The NSW Government recognises the strengths and opportunities, and also the difficulties facing rural and regional New South Wales. Regional New South Wales makes a key contribution to the State economy, while significant economic, social and environmental stress is being experienced by some communities with specific needs in relation to access to social and economic infrastructure.

A separate Budget Paper on regional budget highlights provides further details on rural and regional initiatives. Sector-specific priorities for health, education, social welfare, transport, law and order and the environment are summarised below.

Service Access Measures

The Government is pursuing improvements to service access for rural and regional New South Wales. These generally take a whole-of-government approach to service delivery, in many cases supported by advanced communication technologies, and include the following:

- An additional 38 Government Access Centres - one-stop shops for local, state and federal services - will be opened in small country towns across New South Wales following the successful opening of seven such centres on a pilot basis.

  These centres provide consumer protection services and facilitate driver's licence renewals, provision of boating and fishing licences, car registration and birth certificates. Three centres will be opened in 2001-02 with a commitment of $1.8 million, and the remainder will be open by June 2003.

- Regional Service Delivery Plans jointly formulated by various Government agencies in each region to make coordinated decisions about that region's service provision.

- Continued implementation of the *connect.nsw* project which uses information technology and the internet to improve Government service provision, particularly for cross-Government IT projects.

Service Delivery Measures

The 2001-02 Budget includes continuing and new initiatives that specifically benefit regional and rural New South Wales including:

- An additional $45 million (an increase of 28.6 percent) will be allocated for mental health services, and dental funding for pensioners and disadvantaged people will be increased by an average 28.9 percent, as part of the rural health initiatives over the first three years of the Government Action Plan for Health;

- Additional caseworkers for frontline child protection, and specialist training positions will be allocated in rural and regional areas to assist frontline workers providing welfare services;

- The proportion of funding for the arts going to the regions will be increased, including the rebuilding and modernisation of 28 arts buildings in country New South Wales, $1.5 million for regional music centres and $500,000 to shift film-making from the city to country towns;

- One-stop shops will be established to deliver natural resource programs involving seven separate agencies. For example, a farmer seeking advice on salinity will be able to obtain all relevant NSW Government services (land, water, forestry and farm assistance) from a single access point; and

- Continuing support will be provided for programs that attract and strengthen the existing jobs base in regional and rural New South Wales, including the Regional Business Development Scheme, the Regional Economic Transition Scheme, the Country Lifestyles Program, the Hunter Advantage Fund and the Illawarra Advantage Fund.

Decentralising jobs

The Government will continue to decentralise Government jobs where feasible. During 2001-02 and 2002-03, more than 1,000 Government jobs are expected to be created or relocated to country New South Wales.

Some key Government operations have been relocated outside the Sydney metropolitan area. Relocation of operations to generate jobs and improve service access will continue to be undertaken where feasible. Some examples of relocations include:

- Superannuation Administration Corporation to Wollongong, to be completed in 2001-02 (involving approximately 350 employees);

- WorkCover Authority to Gosford in early 2002. This is the largest relocation of a State Government organisation (approximately 400 employees) to regional New South Wales in over 30 years;

- Smaller-scale relocations include a Police Firearms Registry in Murwillumbah (50 jobs created in the Far North Coast) and a Native Vegetation Unit in Wellington (24 jobs created in the Central West).

Rural and Regional Infrastructure

The Government is committed to maintaining and enhancing rural and regional infrastructure. The 2001-02 Budget includes the following measures:

- Upgrade of acute mental health, oncology, orthopaedics and renal services at rural base and referral hospitals; funding for rural information technology infrastructure within rural and regional hospitals; and provision to redevelop 34 small rural health facilities over the next three years, with construction to commence on 19 facilities in rural and remote communities during 2001-02;

- New capital works initiatives for both schools and TAFE in rural and regional New South Wales total almost $25 million. Key projects for schools include Mullumbimby High School, Dubbo Multi-Campus College, Great Lakes College and Merimbula Public School; and for TAFE, refurbishment of Albury TAFE Campus, an Aboriginal Development Centre at Dubbo TAFE Campus, and a building and construction industry work area at Tamworth TAFE Campus;

- New rail passenger carriages and other equipment upgrades in the Hunter region and for intercity routes from the Central Coast, the Blue Mountains and Illawarra; and

- An additional $60 million to be spent over the four years to 2004-05 under the Country Towns Water Supply and Sewerage Program. A total of $66.8 million will be provided under the Program in 2001-02.

PROVIDING THE BEST POSSIBLE EDUCATION OPPORTUNITIES

The NSW Government is committed to providing children with the best possible school education, giving children a fair start in their preparation for life and work. Beyond high school, the Government is committed to ensuring that students have access to training which will help them to build the essential skills required for the workplace throughout their working lives.

Strategic directions for education supported in the 2001-02 Budget include:

- For Schools, continuation of the State Literacy and Numeracy Plan; more intensive use of computers as learning aids, with ongoing replacement of 90,000 computers through leasing arrangements and the acquisition of an additional 25,000 computers; better opportunities for teacher training in using new technology in the classroom; and key initiatives relating to:

  - the staged introduction of expanded internet services for students and teachers in Government schools and TAFE; and

  - the introduction of Computing Skills Assessment tests for students in Years 6 and 10.

- For Technical and Further Education services, support will continue to be provided for TAFE scholarships and students at risk programs; ongoing development of partnerships between TAFE NSW and industry to deliver flexible and client-friendly training programs; and joint TAFE and schools initiatives particularly addressed to the needs of youth.

- A major statewide upgrade of the buildings, facilities and grounds of public schools will commence from 2001-02. The program includes the construction of 31 new schools; upgrades to classrooms, libraries and security at 1,000 public schools; improved facilities for students, teachers and school staff; and landscaping, new fencing and general improvements at older schools.

ADVANCING THE PUBLIC HEALTH SYSTEM

Developments within the NSW Health system are being driven by the Government Action Plan for Health, which implements the recommendations of the NSW Health Council and the Ministerial Advisory Council on Health Services in Smaller Towns.

Strategic directions for health services in the 2001-02 Budget include the following:

- Funding committed in 2000-01 to support reform initiatives under the Government Action Plan for Health, amounting to $45 million per annum, is being used to reduce pressure on local emergency departments, to improve the care of patients with chronic cardiovascular, respiratory or cancer related illnesses and to enhance medical and surgical inpatient services.

- A total of $7,770 million is committed to health services in 2001-02, 4.7 percent higher than in 2000-01, with additional growth funding to provide for: increases in medical and surgical procedures at hospitals throughout the State; additional intensive care beds; major redevelopment in the Tweed Valley; expansion of aged care, cardiac, palliative and respiratory rehabilitation and extended care services in the Mid North Coast; and increased outpatient procedures.

- The 2001-02 Budget provides $1,980 million for health capital works over the next four years ($529 million in 2001-02), with a guarantee to the Department of Health of $480 million per year for four years to build and upgrade hospital services. A further $49 million has been provided in 2001-02 to accelerate several key projects in the Government Action Plan for Health. Capital works funded in 2001-02 include construction or upgrading and redevelopment of facilities in metropolitan centres as well as significant investment in health facilities in regional and rural New South Wales.

SUPPORTING FAMILIES, CHILDREN AND THE DISADVANTAGED

The Government aims to provide high quality care and protection and to promote opportunities for those in vulnerable positions. This includes families, young people and children, frail older people, people with disabilities and their carers. In line with these objectives, the 2001-02 Budget continues to support the following strategic directions in respect of social welfare services:

- Early intervention and prevention programs through the extension of the *Families First* network across New South Wales by 2002-03;

- Continued implementation of the *Children and Young Persons (Care and Protection) Act 1998*;

- Ongoing review and reform of out-of-home care services, including improving the quality and capacity of services;

- Enhancement of the disability services system, including additional supported accommodation places; an immediate assistance pool for clients in crisis; local area coordination to improve response time and strengthen informal supports in the community; and the relocation of residents from large disability residential facilities;

- Growth funding for the Home and Community Care program;

- The development of a NSW Action Plan on Dementia; and

- Continuing support for the Assistance to Aborigines program and various concessions for transport, local council rates and electricity, water and sewerage.

Improving the Quality of Public Transport

The Government aims to provide New South Wales with efficient and accessible transport infrastructure and services that support both the growth of the State's economy and improvements in the quality of life of NSW residents. The Government continues to implement reforms to achieve increased patronage of public transport and to make transport services more accessible, reliable and safe.

The Government's initiatives include *Action for Transport 2010*, a plan which aims to develop the State's transport links and support the goals of economic development and jobs, social justice, environmental protection and improved financial performance of Government.

The Plan includes a number of major road developments to support rural and regional industries and communities, as well as improvements in Western and North Western Sydney.

In addition to the broader and longer-term objectives of *Action for Transport 2010*, measures in the 2001-02 Budget continue enhancements in public transport safety and reliability initiated in 2000-01 under the rail improvement program.

Major initiatives are listed below:

- Commencement of construction of the Parramatta Rail Link, with expenditure of approximately $145 million in 2001-02;

- Commissioning of the new Millennium Trains, with $90 million to be spent in 2001-02;

- Measures to enhance rail safety and reliability. These include better track and carriage maintenance, refurbishment of older trains, and new signalling junctions and related safety measures, with an allocation of $170 million in 2001-02;

- Measures to increase the capacity of the existing rail network through enhancement of the East Hills, Richmond and Dapto to Kiama lines and new turnback facilities, with projected spending of $49 million in 2001-02;

- A major upgrade of station access, security and facilities across the rail network, with funding of $60 million in 2001-02; and

- A major upgrading of Windsor Road to be completed in 2006 at a total cost of $323 million ($47 million in 2001-02). The upgrade will include an expansion of capacity to four lanes. Support will also be provided for other major road construction, some with Commonwealth funding.

PROTECTING THE COMMUNITY

The Government aims to better protect people and property by preventing, detecting and investigating crime, providing justice through the operation of the courts and minimising the impact of emergency incidents.

Most of the 2001-02 Budget allocation for public order and safety supports measures initiated in previous years. Significant activities in respect of law and order services include the following:

- The implementation of the next stage of the plan to increase the frontline strength of the Police Service by 2,110 officers in accordance with the Government's election commitment. This is being achieved by recruiting additional police officers and undertaking a range of measures to redirect existing police resources;

- Funding of $6 million will be provided for improvements to the Police Service's Country Radio Communications Network, and almost $18 million for the continuing development of various information technology applications within the Service;

- $3.6 million will be made available to the Department of Juvenile Justice for various drug action initiatives, including diversionary counselling and group works program, drug rehabilitation program and Youth Drug Court;

- Additional funding of $8 million will be provided in 2001-02 for the expansion of the Department of Corrective Services' correctional bed capacity to cope with the increase in inmate numbers arising from the increase in frontline police numbers;

- Capital works expenditure will include almost $59 million in 2001-02 for the three new gaols under construction at Kempsey, Parklea and South Windsor;

- Construction will commence on a new Children's Courts complex at Parramatta (estimated total cost $17.3 million) and a new Children's Court in the Hunter District at Worimi (estimated total cost $6.5 million);

- $18 million is being provided to the NSW Fire Brigades to purchase fire pumpers, aerial appliances and special appliances;

- A three-year program to refit Rural Fire Service vehicles with more sophisticated protection systems and fireproof blankets will continue in 2001-02 at a cost of $5 million. In addition, funding of $19.2 million will be provided in 2001-02 for improvements to the management arrangements of the service, resulting in the transfer of the employment of fire control officers from Local Councils to the State Government.

PRESERVING THE ENVIRONMENT

The Government is committed to preserving and protecting the natural environment. Strategies in the 2001-02 Budget combine new and ongoing initiatives, including the following:

- Testing of the carbon credit market, in line with the Government's carbon sinks 1998 legislation. Some 250,000 tonnes of carbon credits stored in existing plantation forests will be offered for sale;

- Implementation of measures to meet salinity targets set by all Catchment Management Boards within the NSW Murray-Darling Basin as part of the NSW Salinity Strategy;

- Administrative improvements such as the introduction of a timber product labelling system and the setting up of one-stop shops to provide advice on the natural resource programs of the Government; and

- Tackling urban congestion through the *Action for Transport 2010* plan, which includes strategies for safeguarding the environment, improving air quality, reducing car dependency and getting more people on public transport.

In support of the Government's commitment to the environment and consistent with the broad strategies listed above, the 2001-02 Budget provides for the following:

- The implementation of the *Water Management Act 2000*;

- A capital works allocation to the National Parks and Wildlife Service to acquire additional lands with high conservation value, significantly extend and upgrade sewerage infrastructure and public amenities in parks, and develop and upgrade recreational facilities in regional and metropolitan parks;

- Support for the implementation of reduction in air and noise emissions;
- Support for the State's contribution towards floodplain management;
- Environmental compliance measures by the Environment Protection Authority; and
- A comprehensive program for the Zoological Parks Board to rebuild and modernise facilities and exhibits, for research and for public education.

1.2 FISCAL STRATEGY STATEMENT

This section describes recent developments and progress against fiscal targets and the implementation of key principles underpinning the fiscal strategy.

MEDIUM-TERM FISCAL STRATEGY

New South Wales' medium and long-term fiscal strategy and financial management policies are underpinned by the principles in the *General Government Debt Elimination Act 1995*, and beyond this, also emphasise the broad financial aggregates of the total State sector. Key elements of the NSW fiscal strategy are summarised in Box 1.1, and were described in detail in the 2000-01 Budget Paper No. 2.

Box 1.1: Key Elements of the NSW Fiscal Strategy

- Reducing Net Financial Liabilities to a sustainable level through the prudent management of both assets and liabilities, which takes into account in addition to Net Debt:
  - other General Government (GG) sector *Net Financial Liabilities* - ie, unfunded superannuation and insurance;
  - other Net Financial Liabilities of the *Total State sector*, which includes the Public Trading Enterprise (PTE) and Public Financial Enterprise (PFE) sectors in addition to the GG sector;
- Controlling growth in the net cost of services; and
- Maintaining a tax regime conducive to business investment and ensuring a reasonable degree of predictability about the level and stability of tax rates.

Recent Developments

The NSW economy has experienced strong growth in recent years, and underlying revenue growth has generally been robust. This has helped the Government to fund growth in essential services while delivering surpluses in the last five years.

Along with these surpluses, returns of capital from the PTE sector have also been applied towards reducing General Government Net Debt (details are given in section 5.3). Additional funding of superannuation liabilities has also been possible in the last two years. The State therefore has a strong starting position for the 2001-02 Budget, which is ahead of both its General Government Net Debt and Net Financial Liabilities projections of the previous two Budgets.

Growth in NSW Gross State Product (GSP) has softened markedly in 2000-01 and is expected to remain subdued in 2001-02. There remains considerable short-term uncertainty around the extent of the slow-down domestically, which will be heavily influenced by developments abroad. The strategy of consolidating finances and reducing net debt in recent years means that New South Wales' fiscal fundamentals are now very sound, and the State is well positioned to weather a period of weaker growth (section 1.3 details the economic outlook).

NSW GSP is expected to grow by around 2¾ percent in 2001-02, a little stronger than the expected outcome for 2000-01 of just 2 percent, but not reaching the near 4 percent rate of prior years.

In the 2000-01 Budget Papers, it was recognised that the economy could not indefinitely retain its recent strength and corresponding robust growth in asset-related tax revenue (primarily from conveyancing and financial transactions). In the event, revenue growth slowed. The 2001-02 Budget estimates incorporate continued subdued growth in total revenue.

The NSW Budget is not expected to reap any net benefit from growing GST revenues until late in this decade[1].

On the expenditure side, a number of commitments made after the 2000-01 Budget have resulted in higher growth in underlying expenses in 2000-01 (5.1 percent in nominal terms) than the Budget projection (3.4 percent). These expenditure commitments have included both increases required to maintain levels of service delivery for existing programs, and funding for new measures. A significant proportion will have enduring impacts on future Budgets.

[1] *The impact of tax reform on the NSW Budget is described in more detail in Chapter 8.*

Consequences for Fiscal Aggregates in 2001-02 Budget

General Government Net Debt is projected to decline from $7,531 million or 3.1 percent of GSP ($6,352 million or 2.7 percent of GSP excluding temporary debt raised to fund the prepayment of superannuation[2]) in June 2001 to $4,828 million (1.6 percent of GSP) by June 2005. This compares with $12,027 million (7.3 percent of GSP) in June 1995. At current levels, and those projected in this Budget, General Government Net Debt remains on track to achieve both the medium-term target of Net Debt being at a sustainable level by June 2005, and the long-term debt elimination target.

Although the debt targets required by the *General Government Debt Elimination Act 1995* suggest targets for the *cash* result, the broader focus of the fiscal strategy on managing the balance sheet, encompassing other liabilities in addition to Net Debt, makes it appropriate to budget for adequate *Net Lending* surpluses.

This is because Net Lending is the accrual measure most closely matching prospective changes in *Net Financial Liabilities*[3].

For the remainder of the Budget Papers, the term *Budget Surplus* refers to the *Net Lending Surplus*, except where the *cash* surplus is being discussed in reference to targets in the *General Government Debt Elimination Act 1995*.

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[2] *See 2000-01 Budget Paper No 2 for further details.*

[3] *Valuation changes, which are not included in Net Lending per the Government Finance Statistics (GFS) standards of the Australian Bureau of Statistics (ABS), have accounted for material changes in Net Financial Liabilities in the past few years. However, for the forward estimates there is no basis on which to assume future valuation changes. From 2001-02 onwards, Net Lending therefore most closely reflects changes in Net Financial Liabilities.*

Table 1.1: Net Financial Liabilities and Net Debt, Total State and General Government Sectors ($million)

As at 30 June	General Government		Total State	
	Net Financial Liabilities[a][c]	Net Debt [b]	Net Financial Liabilities	Net Debt [b]
Actual:				
1995	32,594	12,027	43,717	19,443
1996	32,194	10,849	44,323	19,398
1997	28,937	10,817	41,222	18,846
1998	28,486	10,159	40,794	18,750
1999	27,144	12,818	40,246	21,487
2000	23,390	11,222	36,101	19,701
Estimated:				
2001	22,481	7,531	37,280	19,103
2002	21,944	6,176	37,561	18,389
2003	21,864	5,809	37,481	18,022
2004	21,832	5,598	37,449	17,811
2005	21,272	4,828	36,889	17,041

(a) *Excludes the equity assets of the PTE and PFE sectors.*

(b) *Including the impact of temporary debt associated with prepaid superannuation of $3,264m in 1998-99, $2,250m in 1999-2000 and $1,179m in 2000-01.*

(c) *Data for 1995 to 2000 differ from the 2000-01 Budget as they have been adjusted to put them on a comparable basis with the 2001-02 Budget estimates as follows: (1) unfunded superannuation liabilities exclude obligations to the Commonwealth for universities; and (2) Net Financial Liabilities exclude Provisions for Doubtful Debts as determined by the ABS.*

Projected General Government Budget surpluses average about $330 million per annum over the Budget estimates period. These contribute to a projected decline in General Government Net Financial Liabilities from $22,481 million (9.4 percent of GSP) in June 2001 to $21,272 million (7.1 percent of GSP) by June 2005.

As shown in Table 1.1, both Net Financial Liabilities and Net Debt for the Total State and General Government sectors have fallen very significantly since June 1995, and are projected to fall further over the forward estimates period. Net Financial Liabilities are further discussed later in this section and in Chapter 5.

RECENT PERFORMANCE AND PROGRESS AGAINST FISCAL TARGETS AND PRINCIPLES

Reporting requirements of the *General Government Debt Elimination Act 1995* are addressed in this section, which contains:

- the 2001-02 Budget Policy Statement;

- an assessment of the application of the seven fiscal principles; and

- projections of the ability of the Government to achieve the fiscal targets, and a review of progress in achieving the fiscal principles.

Three-year projections of all relevant economic and financial variables are required by the *General Government Debt Elimination Act 1995*. These are provided in section 1.3 and Chapter 2.

The medium and longer term focus of the Act requires assessment of the attainment of the fiscal targets and compliance with the fiscal principles to be over a several year period. This recognises that fiscal outcomes will be affected by cyclical economic and other one-off factors in the short term.

The fiscal principles and targets in the *General Government Debt Elimination Act 1995* against which progress is reviewed in the following sections are:

- Adherence to fiscal targets, consisting of:

  - a ***short-term*** fiscal target (achievement of a sustainable General Government Budget surplus by 1998-99);

  - a ***medium-term*** fiscal target (reduce General Government Net Debt to a sustainable level by 30 June 2005); and

  - a ***long-term*** fiscal target (eliminate General Government Net Debt by 30 June 2020).

- Maintaining or increasing General Government real Net Worth per capita;

- Funding employer superannuation liabilities;

- Asset maintenance;

- Constrained growth in net cost of services and outlays;

- Prudent risk management; and

- Tax restraint.

1. Adherence to Fiscal Targets

As the 2001-02 Budget is on an accrual basis, and fiscal targets in the *General Government Debt Elimination Act 1995* are cash-based, both cash and accrual results are presented in this section[4].

The General Government sector had a cash surplus of $867 million in 1999-2000, and is expected to have a $484 million cash surplus in 2000-01, exceeding the 2000-01 Budget estimate of $314 million.

The substantial cash surpluses of recent years, and the use of equity returned from electricity distributors and generators in 2000-01, have contributed to an estimated $4,496 million cumulative reduction in General Government Net Debt between June 1995 (the Act was assented to in December 1995) and June 2001. Over the same period, unfunded superannuation liabilities have been reduced by an estimated $4,174 million. Further details on movements in debt and unfunded superannuation are provided in Chapter 5.

The 2001-02 Budget estimates take into account a decline in conveyancing duty in 2000-01, and expectations that output and employment growth will be soft in 2001-02. Given the economic outlook and the further tax cuts introduced in this Budget, the projected surpluses over the first three forward years are smaller than in the recent past (Table 1.2).

The Operating Surplus (accounting basis) declines slightly from $1,575 million in 2000-01 to $1,454 million in 2001-02, and further to $895 million in 2002-03 due mainly to additional expenditure commitments and more subdued growth in tax revenues. The Operating Surplus improves to $1,505 million by 2004-05.

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[4] *Under the previous cash GFS standard of the ABS, the cash result was defined as the difference between cash outlays (recurrent and capital) and cash revenues (tax and nontax). The accrual GFS standards introduced in 1999-2000 include three financial statements: the Operating Statement, the Cash Flow Statement and the Statement of Financial Position. The new cash measure shown in Table 1.2 is broadly equivalent to the former GFS cash result while being derived from the Cash Flow Statement.*

Table 1.2: Operating Result and Budget Result, General Government, 1996-97 to 2004-05 ($million)

YEAR	Accounting Operating Result [(a)]	Budget (GFS Net Lending) Result	GFS Cash Surplus/-Deficit [(b)]
1996-97 Actual	2,560	n.a.	151
1997-98 Actual	2,093	26	48
1998-99 Actual	2,007	187	597
1999-2000 Actual	4,471	1,301	867
2000-01 Projection	1,575	221	484
2001-02 Estimate	1,454	368	321
2002-03 Estimate	895	334	331
2003-04 Estimate	916	171	35
2004-05 Estimate	1,505	639	625

n.a. - not available.

(a) *After abnormals.*

(b) *The figure for 1996-97 is on the former ABS GFS cash basis. From 1997-98 onwards, the data is on the new ABS GFS cash basis, with adjustments for prepaid superannuation in each of 1998-99, 1999-2000 and 2001-02.*

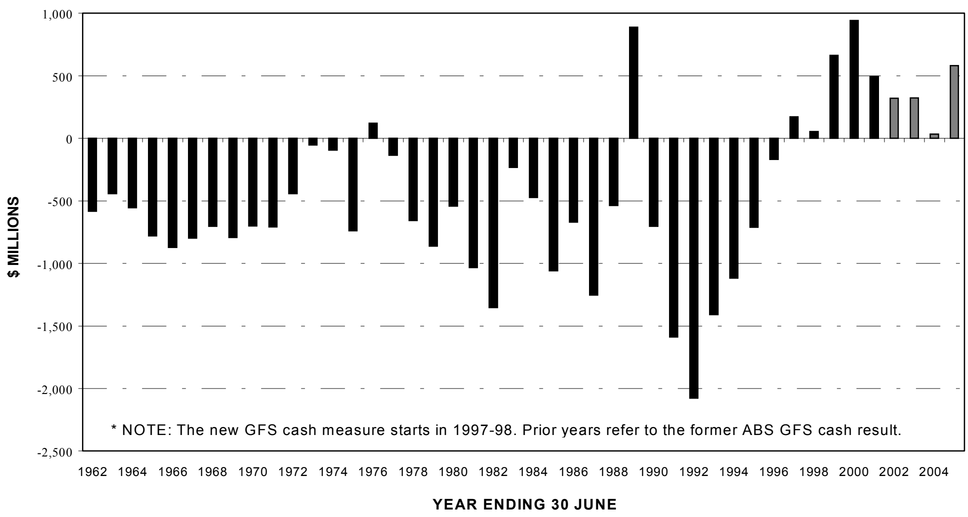
Projected General Government Budget surpluses in the four years to 2004-05 total $1,512 million, and cash surpluses total $1,312 million. The cash surpluses that commenced in the late 1990s are striking given that only two cash surpluses have been achieved between 1961 and 1995, the latter following a series of very large cash deficits in the early 1990s (see Chart 1.1). These results were achieved at the same time that the Government implemented a comprehensive program of tax reductions and funded the 2000 Olympics.

The *short-term target* in the *General Government Debt Elimination Act 1995* - a sustainable General Government Budget Surplus by 1998-99 - was achieved with a cash surplus of $597 million in that year. The projected cash outcomes provide scope for reductions in Net Debt consistent with the *medium-term target*, as shown in the forward estimates of General Government sector Net Debt in Table 1.1 above. The medium-term target, in turn, represents progress towards the *long-term target.*

The *General Government Debt Elimination Act* specifies a June 2005 medium-term target date for reducing General Government Net Debt to a sustainable level. The debt level can be regarded as sustainable if it is low enough for a sharp economic downturn to be weathered without harsh corrective action (significant spending cuts and/or tax increases) being required to manage the level of debt.

The strong surpluses in recent years have enabled the State to reduce General Government Net Debt and Net Financial Liabilities to levels lower than projected in the previous two Budgets. With underlying Net Debt (ie, excluding the impact of the superannuation prepayment) estimated to be $6,352 million (2.7 percent of GSP) in June 2001, the medium-term target of reducing General Government Net Debt to a sustainable level can be comfortably achieved by June 2005 or earlier.

Chart 1.1: NSW Underlying Budget Result, GFS Cash Basis* 1961-62 to 2004-05 (at constant 2001-02 prices)



2. General Government Sector Net Worth

Net Worth is defined as *Total Assets* less *Total Liabilities.* The second fiscal principle in the Act is to ensure that the Net Worth of the General Government sector is at least maintained in real terms.

The available history and projections for General Government Net Worth are given in Table 1.3 (the balance sheet data available prior to 1997 relates to the Consolidated Budget Sector, not strictly comparable with the General Government sector).

General Government Net Worth was $88,069 million in June 2000, and is estimated to be $89,552 million in June 2001 (including PTE/PFE equity). The June 2000 figure is about $1,500 million above the 2000-01 Budget estimate due mainly to a higher than expected Budget Surplus and valuation changes.

General Government Net Worth increased by an average 7.9 percent per annum in the four years to 30 June 2001, exceeding the 2.5 percent per annum required to maintain Net Worth in real terms over the four-year period.

Net worth is projected to be 44 percent above its June 1997 level by June 2005, a real per capita increase of around 10 percent. From 2002-03 onwards, General Government Net Worth projections in Table 1.3 are conservative in making no allowance for the growth in PTE and PFE equity that is typically experienced.

Table 1.3: Trends in General Government Net Worth[(a)]

At 30 June	Assets $m	Liabilities $m	Net Worth $m
Actual[(b)]			
1997	104,711	38,565	66,146
1998	111,151	38,454	72,697
1999	116,282	37,296	78,986
2000	121,250	33,181	88,069
Estimated			
2001	121,641	32,089	89,552
2002	123,808	31,616	92,192
2003	124,856	31,757	93,099
2004	125,785	31,758	94,027
2005	127,366	31,832	95,534

(a) Assets and Net Worth of the General Government sector defined on an ABS basis include equity investment in the PTE and PFE sectors of the order of $46,600 million at 30 June 2001.

(b) Prior years' data on Total Assets and Net Worth differ from those reported in the 2000-01 Budget due to adjustments to make prior years comparable with 2001-02 Budget estimates. The adjustments reflect (1) the ABS's exclusion of Provision for Doubtful Debts from the GFS balance sheet; and (2) the exclusion of superannuation obligations of universities.

3. Funding Employer Superannuation Liabilities

Unfunded superannuation liabilities account for the majority of non-debt liabilities for both the General Government sector and the Total State sector. The third fiscal principle in the *General Government Debt Elimination Act 1995* requires that accruing superannuation liabilities of both the General Government sector and the Public Trading Enterprise sector be fully funded, and that accrued unfunded employer superannuation liabilities be extinguished over time.

The trend in General Government unfunded superannuation liabilities from 1995 is given in Table 1.4 and is discussed in Chapter 5. In the past five years, unfunded liabilities decreased in accordance with the third fiscal principle. The large reduction in 1999 was the result of the prepayment of three years' worth of employer superannuation contributions (detailed in previous Budget Papers). Subsequent above average investment return is estimated to provide a favourable financial impact of at least $800 million on net superannuation liabilities by June 2002.

While the 1999-2000 Budget assumed zero employer contributions until 2002-03 because of the superannuation prepayment, subsequent additional contributions were $587 million in 1999-2000 and an expected $243 million in 2000-01 (against $320 million budgeted). General Government unfunded superannuation which amounted to well over 7 percent of GSP in June 1995, is estimated to decline to 3.3 percent by June 2001, and is projected to also be around that percentage by June 2005.

Table 1.4: Trends in Net Unfunded Superannuation, Total State and General Government Sectors ($million)

At 30 June	General Government (a)(c)	Total State (c)
Actual:		
1995	12,037(b)	14,041
1996	12,976(b)	14,757
1997	11,765	12,216
1998	11,852	11,988
1999	7,952	8,179
2000	5,686	5,284
Estimated:		
2001	7,863	7,593
2002	8,990	8,872
2003	9,269	9,151
2004	9,530	9,412
2005	9,753	9,635

(a) Data for 1995 to 2000 differ from those in the 2000-01 Budget due to an adjustment to exclude obligations to the Commonwealth for universities. This adjustment makes data for prior years comparable with the Budget year and forward estimates.

(b) Refers to the Budget sector.

(c) Unfunded superannuation of the General Government sector is greater than that of the Total State sector from 2000 onwards because superannuation for the PTE sector is over-funded in that period.

As a result of higher than originally planned employer contributions, liability management initiatives and favourable investment returns the Government has brought forward the target date for full funding of superannuation from 2045 to 2030. The funding plan in 1995 projected that unfunded liabilities of the Budget Sector would be $14,200 million at June 2001. The actual level of unfunded liabilities is $7,863 million (for General Government). This is $6,337 million or 45 percent less than the 1995 estimate.

A recent Triennial Review of the schemes' liabilities as at 30 June 2000 has led to valuation changes. The improved position confirmed by the review allowed the target date for the achievement of full funding to be brought forward by fifteen years to 2030. The 2001-02 Budget estimates therefore adopt a revised funding plan.

While earnings on the superannuation fund's assets are expected to be weak in 2000-01, this is not expected to compromise the achievement of the 2030 target date under the new funding plan.

The projected increase in the unfunded superannuation liability of $1,890 million over the forward estimates period reflects the fact that the assets accumulated from contributions and fund investment returns are initially smaller than the liabilities, which are projected to grow at a faster rate over the first half of the period. The gross liability is expected to reach a peak in 2015 and decline thereafter. Nevertheless the 2015 peak is around $3,500 million below that expected when the former funding plan was introduced in 1995. After 2015, the rate of reduction in assets is overtaken by the rate of reduction in gross liabilities resulting in a decline of net liabilities.

4. Asset Maintenance

Infrastructure and other long-life physical assets comprised about 86 percent of General Government Total Assets (excluding PTE and PFE equity) at 30 June 2000. The Government seeks to achieve an appropriate balance in expenditure between creating new capital, including public infrastructure, and efficiently utilising the existing capital stock.

The fourth fiscal principle in the *General Government Debt Elimination Act 1995* requires proper maintenance of the long-lived physical assets of General Government sector agencies. Budget-dependent General Government sector agencies having a total physical asset base of $5 million or more are required to submit Asset Maintenance Plans to Treasury.

The Asset Maintenance Plans 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. This facilitates the efficient and effective management of assets.

Of the 30 General Government agencies required to submit asset maintenance plans, 28 have complied and all have been deemed adequate. The two remaining agencies have prepared or are in the process of preparing separate plans for each of their operating units.

A broader total asset management strategy (which involves asset acquisition, asset maintenance and asset disposal) should provide the context for asset maintenance plans. Further details regarding asset management strategies in the General Government sector, as well as details on the State Asset Acquisition Program (SAAP), are provided in Budget Paper No 4.

The SAAP in 2001-02 will increase by close to 4 percent (to $5,581 million) over that budgeted for in 2000-01, then average about $5,500 million per annum in the three years to 2004-05. The total SAAP will amount to $22,195 million in the four years to 2004-05.

The discretionary component of General Government sector capital acquisitions is projected to be maintained in real terms over the forward estimates period.

5. Constrained Growth in Net Cost of Services and Outlays

The fifth fiscal principle in the *General Government Debt Elimination Act 1995* specifies that the growth in net cost of services and in budget outlays (both current and capital) should be kept at or below the growth in inflation and population (ie. zero growth in real per capita terms).

In the five years to 1999-2000, average real per capita growth in total outlays (current plus capital outlays on the former ABS GFS cash basis) was about 2 percent per annum.

The accrual measure, *net cost of services* (defined as underlying expenses less underlying operating revenues[5]) increased by an average annual real per capita rate of about 1.7 percent from 1997-98 to 2000-01 (the period for which this measure is available).

Deviation from the target was due mainly to the following factors:

- *Demand growth*. Given current demographic and social trends, the rate of growth of the real cost of maintaining existing policies in the health and community service sectors in particular, has exceeded the rate of growth of the population. While Olympics-related spending added marginally to outlays growth in the lead-up to the 2000 Sydney Olympic and Paralympic Games, the maintenance and upgrading of ageing capital stock in some portfolios has also necessitated increased outlays in recent years.

- *Policies to raise standards of provision for some essential services*. Commonwealth Grants Commission data from the early 1990s show important areas where the level of service provision in New South Wales was below that of other States, including public health, nursing homes, pre-school education, public safety and emergency services and some economic services.

The 2001-02 Budget and forward estimates have been framed to meet the principle of constrained growth in net cost of services while providing an adequate allowance for growth in demand for Government services, and future contingencies. The Service and Resource Allocation Agreements being introduced for a growing number of agencies are helping to reduce the risk of unanticipated demands on government, while adding discipline to agency strategic planning.

For the four years to 2004-05, underlying net cost of services is projected to grow at an average annual rate of 0.8 percent in real per capita terms, the bulk of the growth occurring in the first two years. Chapter 4 provides more detail on the underlying movement in expenses after excluding one-offs and extraordinary items.

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[5] *Underlying expenses are defined as total expenses less material one-off items, structural shifts in expenses, items relating to national tax reform and major non-discretionary expenses (superannuation, finance costs, insurance and depreciation). Operating revenues are likewise adjusted for material one-off items (eg, major asset sales), national tax reform related items and revenue offsets to the expense adjustments (such as those relating to some Olympics transactions). Real growth rates are based on the Government Consumption deflator of the ABS State Accounts, which is a better measure of changes in the cost of Government services than the Consumer Price Index.*

6. Prudent Risk Management

Risk management is required across a broad range of matters, including service delivery, asset and liability management, commercial risks for PTEs, environmental factors and all forms of legal liability, and requires processes to identify and manage those risks.

Fiscal and financial risks[6] are present at three levels:

- the aggregate level (associated with total expenditure, revenue and deficit financing, often arising from changes in the economy and emerging demographic trends);

- the sectoral level, associated with the broad composition of expenditure and revenue sources; and

- the specific program or project level.

New South Wales' AAA credit rating bears testimony to the effectiveness of the management of aggregate level risk associated with the level and composition of debt, largely centralised with the NSW Treasury Corporation.

The sixth fiscal principle in the *General Government Debt Elimination Act 1995* requires General Government agencies to maintain risk management plans dealing with financial and other significant risks. These agency-level plans contribute towards the management of aggregate level risk and sectoral or program/project level risk.

The General Government agencies subject to Service and Resource Allocation Agreements for 2001-02 have been required to identify risks and risk management strategies as in previous years. Over time, with the development and broader application of these Agreements, agency risk identification, management and reporting will be enhanced.

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[6] *Fiscal risk is slightly more specific, and tends to be more directly associated with the management of the Budget, while broader financial risk tends to arise, for instance, from the autonomous operation of financial markets. While there may be considerable overlap between the two types of risk, Governments have traditionally been viewed as having a slightly greater degree of control over fiscal risk via explicit revenue or expenditure policies.*

Additionally, an extensive survey by the NSW Audit Office is in train to ascertain the extent and practice of risk management in agencies. The results of the survey will be used to promote better risk management practice throughout the NSW public sector. The survey complements previous initiatives, including the Treasury *Risk Management and Internal Control Toolkit* and the *Statement of Best Practice for Internal Control and Audit*.

The management of broad financial risk also includes the following:

- *Public Authorities (Financial Arrangements) Act 1987* risk management review - the Act gives many Government agencies the power to borrow and invest funds and enter into various financial arrangements, and provides for State Government guarantees of financial arrangements. Treasury is reviewing approvals under the Act to ensure that the risk of significant liabilities arising from approved arrangements is minimised. Further detail of the review is provided in section 5.6.

- Guidelines on investment and liability management performance and reporting are issued or updated from time to time via Treasury Circulars. The insurance risks of all Budget-funded General Government agencies and a number of Government authorities are covered by the Government's own self-insurance scheme, the Treasury Managed Fund. Section 5.7 provides further details.

- Ownership risks from Government businesses are managed through, *inter alia*, Statements of Financial Performance for non-corporatised Public Trading Enterprises and Statements of Corporate Intent for State Owned Corporations which identify all financial and operating risks as part of the annual performance agreement between the Government (as shareholder) and the Government business. These agreements document the financial performance targets and associated risks for the year, and performance is monitored against targets on a quarterly basis.

7. Tax Restraint

The seventh principle in the *General Government Debt Elimination Act 1995* requires that tax rates be restrained to the maximum possible extent, and that policies be pursued consistent with a reasonable degree of predictability about the level and stability of tax rates for future years.

New South Wales property and asset market activity was strong in the three years to 1999-2000, leading to strong growth in property-related and financial transactions taxes. Strong, partly cyclical, employment growth assisted payroll tax revenue growth. Cyclical factors and not policy changes were largely responsible for the significant rise in the level of tax revenues during this period.

However, in 2000-01 the growth in tax revenue was significantly lower than the previous year mainly because of a reduction in receipts of some taxes such as conveyancing duty (-13.8 percent), debits tax (-1.6 percent), and taxes on motor vehicle ownership and operation (-2.3 percent). Revenue growth is expected to pick up but remain subdued in 2001-02 compared with the three years to 1999-2000.

Policy changes from 1998-99 have significantly reduced the tax burden. Table 1.5 shows the effect of tax policy changes on revenue in each year. New South Wales' tax burden is expected to decline over the forward estimates period as a result of the tax reduction measures in this and previous Budgets.

By 2004-05 the net effect of all tax policy changes since 1994-95 will have been a net real reduction in the order of $800 million per year. This excludes reductions associated with the removal or restructuring of State taxes from 2000-01 as a result of national tax reform.

In 1999, the New South Wales cross-subsidy to other States was marginally reduced through the Commonwealth fiscal equalisation system, and the State made the last of three annual Fiscal Contribution Payments to the Commonwealth. This allowed payroll tax and land tax rates to be cut in the 1999-2000 Budget.

The 1999-2000 Budget provided for further reductions in payroll tax rates on 1 July 2001 and 1 July 2002 as well as further unspecified tax cuts of $150 million in 2001-02 and $175 million (full-year cost) in 2002-03.

The 2000-01 Budget brought forward by six months, to 1 January 2001, the cut in the payroll tax rate from 6.4 percent to 6.2 percent.

Table 1.5: Annual Contribution of New Policy Changes to Tax Collections[(a)] ($million)

Year	Policy Induced Tax Changes, Current Terms[(b) (c)]
1990-91	310
1991-92	80
1992-93	240
1993-94	100
1994-95	(-) 40
1995-96	15
1996-97	180
1997-98	295
1998-99	(-) 95
1999-2000	(-) 395
2000-01	(-) 220
2001-02	(-) 270
2002-03	(-) 325
2003-04	(-) 5
2004-05	(-) 5

(a) Table 1.5 shows in any one year only the impact of measures in that year, and (unlike Table 3.2 in Chapter 3) does not include the cumulative impact of measures introduced in prior years.

(b) Estimates of the effect of new policy on revenue in each year. Where the tax change commenced during the year, and therefore had only a part year effect in that year, the balance is included in the following year. For example, if a policy has a part-year impact of $50m in the year it commences and a full year impact of $100m the following year, the impact of the policy measure would be $50m in each year.

(c) Notes on specific years: (1) from 1999-2000 onwards, the annual indexation of the land tax threshold is treated as a discrete tax change; (2) from 2000-01, excludes the impact of national tax reform and includes the impact of measures introduced in the 1999-2000 and 2000-01 Budgets and foreshadowed in this Budget; (3) 1996-97 to 1998-99 include the tax increases to fund Fiscal Contribution Payments to the Commonwealth; (4) 1997-98 excludes the one-off loss from abolishing business franchise fees and their replacement by Commonwealth Safety Net taxes; (5) 2001-02 includes, in addition to tax reduction measures, the impact of the Insurance Protection Tax to help provide for the Policyholders' Protection Fund.

In total, the 2001-02 Budget includes $237 million worth of tax reductions ($421 million in a full year). This is offset by the recently announced introduction of an Insurance Protection Tax which is intended to raise $69 million a year in order to help provide for the Policyholders' Protection Fund in response to the collapse of HIH Insurance.

Key measures in the 2001-02 Budget include the abolition of debits tax from 1 January 2002 and the suspension of the electricity distributors levy from 1 July 2001. The abolition of debits tax is conditional on New South Wales not being disadvantaged under national tax reform arrangements for acting to abolish this tax early. More details on trends in tax receipts and new tax initiatives in this Budget are provided in Chapter 3.

1.3 THE ECONOMY

INTRODUCTION

Both revenues and outlays are affected by conditions in the economy. Economic factors are most critical in influencing taxes, interest costs and departmental expenses[7].

This section reviews the performance of the economy compared with expectations in the 2000-01 Budget and details the economic forecasts that underlie the 2001-02 Budget.

Domestic and overseas economic conditions weakened during 2000-01. However this was largely the result of temporary and transitional factors which will have played themselves out by year's end.

Growth in economic output is expected to recover in 2001-02, although the labour market will remain subdued by the lagged impact of slower output growth in 2000-01.

Sources of uncertainty in the forecasts include prospects for overseas economies (particularly the United States), the strength and timing of recoveries in dwelling construction and in business confidence, and the outlook for crude oil prices.

RECENT PERFORMANCE [8]

Overall, economic outcomes in Australia and New South Wales in 2000-01 are likely to be less favourable than expected in the 2000-01 Budget due to:

- weaker world economic conditions;
- prolonged high petroleum prices; and
- a larger than anticipated transitory impact from national tax reform.

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[7] *The sensitivity of the Budget to economic variables is analysed in Section 2.6.*

[8] *The economic estimates are based on data available as at mid-May 2001, which included results to June 2000 for Gross State Product, to December 2001 for State final demand and wage costs, to March 2001 for consumer prices, and to April 2001 for employment. Estimates for 2000-01 are subject to more than usual uncertainty due to distortions flowing from the GST and the 2000 Olympics.*

World growth slowed rapidly during late 2000 and early 2001, precipitated by steep declines in profitability and prices for technology shares in the United States. High international petroleum prices also constrained growth in global output. Synchronised downturns appeared to be developing in the United States, Japan and Europe for the first time in over a decade. Economic fundamentals, however, remained sound in most OECD countries except Japan, and timely intervention by monetary and fiscal authorities was generally under way to rekindle demand and boost confidence. It therefore appears likely that world output will make a reasonably rapid recovery from the second half of 2001, setting the foundations for an uplift in world trade and investment.

The world price of crude oil in 2000 averaged 57 percent higher than in 1999, and was more than double its price in 1998, in US dollar terms. Higher world oil prices together with a lower exchange rate raised business costs and reduced the household income remaining after fuel expenses to meet other consumption needs.

The ***Olympic Games*** and NRMA partial demutualisation contributed only modestly to year average growth in New South Wales although they sharply distorted quarterly trends, first boosting State demand in September then dropping out in December. In annual average terms, however, the 2000 Olympics effect was overwhelmed by the steep national downturns in building activity and in business confidence.

Transition to the new Commonwealth tax arrangements had an unexpectedly large temporary impact on Australian and New South Wales economic performance in 2000-01. While it is difficult to isolate the effects of national tax reform from other influences, anticipation of tax changes appears to have brought forward domestic expenditures, amplifying both the strength of domestic demand in 1999-2000 and its subsequent weakness. This was particularly evident in house building and renovation. At the same time, the non-residential building cycle reached a peak in 1999-2000, particularly in New South Wales. Business sentiment, most notably in the small business sector, was dented by the compliance burden and cash flow aspects of the GST. The financial exposure of policyholders following the collapse of HIH Insurance posed another risk to economic growth and confidence.

Economic downturn in the United States also depressed business sentiment, which was swayed by the close historical correlation between trends in the United States and Australia. But unlike the United States, Australia was not weighed down by a disintegrating technology share market, or by an appreciating exchange rate. Australia's share market remained comparatively resilient; while downward adjustment in the A$ exchange rate provided a major boost to net exports, helping to offset weak domestic demand. This was reflected in a halving of the current account deficit as a ratio to GDP.

Revisions to the forecasts

The 2000-01 Budget noted the risks to the forecasts from uncertainty regarding the world economy, the danger of a major share market correction in the United States, and reactions to the new Commonwealth tax arrangements. All of these concerns proved to be well-founded. Treasury's economic forecasts for 2000-01 were downgraded during the year in line with weakening economic indicators and falling business and consumer expectations. Revisions were published in the Half-Yearly Budget Review in December 2000, and current estimates incorporate further revisions to the outlook.

- The downward revision to estimated output growth is attributable in large part to the steep decline in the construction sector. In the first half of 2000-01 compared to a year earlier construction activity in New South Wales declined by 27 percent, while final demand net of construction increased by 4.7 percent.

- On the positive side, business investment in equipment remained very resilient; and public sector demand seemed close to Budget expectations.

- Total final demand growth was substantially stronger in New South Wales (1.8 percent) than in the rest of Australia (1.2 percent) in the first half of 2000-01.

Table 1.6: Revised 2000-01 Estimates[a]

	2000-01 Budget Time	*Half Yearly Review*	*Current Estimate*
Gross State Product	4	3 ¾	2
Employment	2 ¼	2	1 ¾
Unemployment rate[b]	5 ¾	5 ¾	5 ½
CPI (Sydney)	6	6	6
Wages[c]	4	4	3 ¾

Notes:

(a) Year average percent change, unless otherwise indicated.

(b) Year average, percent.

(c) Wage Cost Index, ordinary time earnings, in New South Wales.

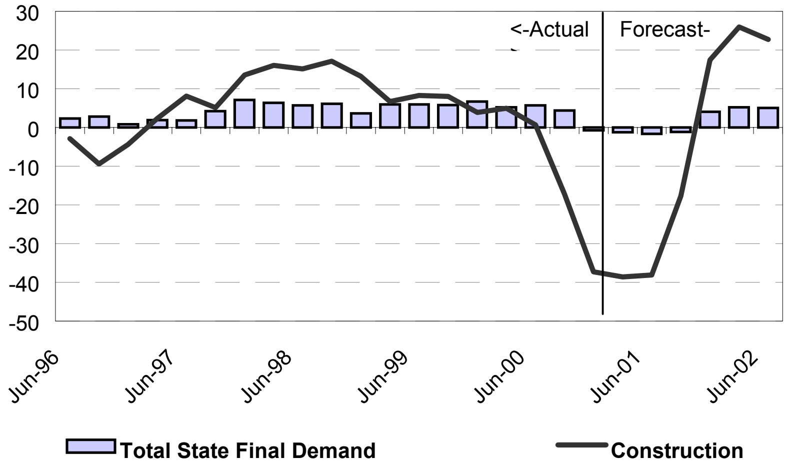
Dwelling construction declined by 24 percent on an annual basis in the first half of 2000-01. While dwelling approvals were again weak in the March quarter, this sector appeared to be close to its trough and some modest resumption in growth seemed likely by year's end, assisted by lower mortgage interest rates and more generous Commonwealth first home owner assistance. Despite steep falls in new construction, house prices remained fairly stable through the first half of the financial year, contributing positively to conveyancing duty collections.

While total business investment is expected to expand in line with 2000-01 Budget forecasts, results for components will differ from previous expectations.

Non-residential construction is likely to be substantially weaker than anticipated in the 2000-01 Budget, in light of its 32 percent decline in the first half. This downturn mainly represents the unwinding of the previous cyclical upswing (from 1997 through early 2000) in Sydney CBD office tower construction.

However investment in ***machinery and equipment*** and ***intangible assets*** (including software) is likely to be somewhat stronger than expected in the 2000-01 Budget. This class of investment increased by 26 percent in New South Wales (substantially faster than in the rest of Australia) in the first half of the year. Given increased difficulties in the technology sector globally, however, investment growth is likely to be slower in the second half.

Chart 1.2: Construction and the New South Wales Economic Cycle
(Annual percent change)



Total ***state final demand*** (domestic demand) growth in 2000-01 is likely to be much more subdued than had been anticipated in the last Budget due to the weakness in construction activity and in general business sentiment. State final demand increased at an annual rate of 1.8 percent in New South Wales in the first half of 2000-01 (compared to 1.2 percent in the rest of Australia). Weakness in domestic demand was partially offset by stronger external demand, reflected in the 25 percent annual increase in merchandise exports from New South Wales. Service exports and interstate commerce also are likely to record substantial improvements, due in part to the 2000 Olympics and in part to the more competitive exchange rate.

While average ***employment*** growth in the first three quarters of 2000-01 was around 2¼ percent, trend employment was declining during most of that period while forward indicators such as job advertising were weak, implying a likely average of around 1¾ percent for 2000-01 as a whole. Job losses through the year to March were greatest in the construction sector and in wholesale trade (reflecting technology-driven rationalisation); while substantial employment gains were recorded in property and business services and in accommodation and catering. Demand was slightly stronger among larger firms than smaller enterprises (whose share of total employment fell by half a percentage point in the first half of 2000-01 compared to a year earlier).

Unemployment reached a low of 5.2 percent in the first quarter of 2000-01 but trended upward thereafter and is expected to average 5½ percent for the year as a whole[9].

The Sydney ***consumer price index*** during the first three-quarters of 2000-01 was 6.2 percent higher than a year earlier, including a significant contribution from a spike in fresh food prices due to poor weather in the March quarter. For the year as a whole average inflation is expected to be in line with the budget forecast reflecting moderate consumer demand, intensified competition putting pressure on margins, and a slightly smaller than expected price effect from the GST.

Growth in ***wage costs*** appears likely to average around 3¾ percent in 2000-01, up from 3 percent a year earlier, but not posing any significant danger to price stability in the longer run. The outcome will remain inside the Reserve Bank of Australia's (RBA) 3½ to 4½ percent "wage corridor" consistent with consumer price inflation of between 2 to 3 percent. ***Average weekly earnings*** (which reflect changes in workforce composition as well as in wage rates) increased by a more robust 4.8 percent annual rate in the first three quarters of 2000-01.

[9] *ABS revisions to labour force definitions in May 2001 had the effect of lowering the unemployment rate for 2000-01 and most prior years by about ¼ percent compared to the 2000-01 Budget estimates.*

Box 1.2: Sources of Economic Strength

Many indicators attest to continued strength and resilience in the national and New South Wales economies at the close of 2000-01:

- The successful 2000 Olympic Games provided a strong and continuing boost to inbound tourism and greater recognition for Australian exporters.
- Business balance sheets are much more solid than at the start of the 1990s.
- Inflation remains subdued despite the GST shock, high world petroleum prices, exchange rate depreciation and the impact of recent flooding in eastern Australia on fresh food prices.
- Wage pressures (as measured by the wage cost index) have been moderate. Interest rate costs to business are declining.
- The lower exchange rate has provided an additional cushion to Australian producers against weakness in overseas markets.
- Although the building boom has ended, it has not left any major excess stock of commercial space or housing.
- The Australian share market has held up better than overseas exchanges such as the United States during 2000-01. Property prices also have remained firm. As a result, wealth effects have remained supportive of private consumption.
- With higher world commodity prices (including contract prices for coal which rose for the first time in several years), Australia's Terms of Trade have improved strongly, providing a further boost to real income.
- Australia's Balance of Payments (current account) deficit has halved from over 6 percent of GDP a year ago to under 3 percent of GDP towards the close of 2000-01.
- Australia's productivity growth continues to out-perform the US and most other OECD countries. Australia's average annual productivity growth during the 1990s was more than double its growth rate during the 1980s.
- Australia, according to the International Monetary Fund, has invested in information and communications technology (ICT) more rapidly than any other country, including the United States. Because Australia is primarily an importer rather than a producer of this technology, however, it is much less exposed than the US and some other ICT producer countries to the current shakeout in this sector.

The combination of strong average earnings growth and initially strong employment growth boosted the total ***compensation of employees*** by 7.3 percent on an annual basis in the first half of 2000-01, up from 5.9 percent in the same period a year earlier. Performance of payroll tax receipts was broadly consistent with this trend.

Interest rates averaged somewhat lower than forecast in the Budget, as the weakening economic outlook led central banks both in Australia and overseas to ease monetary policy aggressively from early 2001. The RBA reduced Australia's cash rate three times totalling 1¼ percentage points, leading to comparable reductions in variable mortgage interest rates. Long bond rates fell during the first three quarters of 2000-01 but rebounded strongly upward in the final quarter on expectations of an imminent economic recovery. Bond rates flow through to the cost of State debt management in the medium term while mortgage interest rates can affect the volume of property transactions and hence conveyancing revenue.

The ***exchange rate*** during the first half of May 2001 was about 10 percent lower than a year earlier against the US dollar and about 5 percent lower against the Trade Weighted Index (TWI). This may have reflected shifting market perceptions about relative medium term growth prospects, relative production versus use of technology, and net foreign asset positions. But such factors seem insufficient to explain the extent of the depreciation during 2000-01, which left the currency appearing substantially oversold.

Domestic ***equity markets*** were fairly stable in the first nine months of 2000-01, contrasting with steep falls in some overseas markets (particularly US technology shares), although differences in performance were less pronounced after adjustment for the lower A$ exchange rate. Daily turnover in exchange traded equities was 10.2 percent higher in the first nine months of 2000-01 than in the same period a year earlier, although growth in share transfer revenue was more subdued.

Trends in revenue collections did not always mirror trends in the economy. Payroll tax receipts were generally more buoyant than implied by aggregate employment, while contracts and conveyancing receipts did not fall to the extent of the slide in dwelling construction. Employment through March appeared to have held up better in larger firms relative to those below the payroll tax threshold; while activity in the established dwellings market appeared to have been sufficient to offset declines in the market for newly constructed dwellings.

In summary, while economic conditions generally were weaker than anticipated during the first three quarters of 2000-01, some aspects of particular consequence for the Budget showed somewhat more resilience. However, subdued prospects for the United States economy and their potential implications for Australia weighed on both business and consumer sentiment toward the close of the financial year.

OUTLOOK FOR 2001-02

While world growth slowed in 2000-01, economic fundamentals remained sound and the strong response of monetary and fiscal authorities should preclude a deep downturn, even though a short lived global recession remains possible. There is the possibility that world growth could escape downturn altogether (in which case business confidence would rise and hence economic outcomes for the New South Wales and Australian economies would be stronger than assumed in Table 1.7). The most likely course of events is for economic slowdown abroad to be followed by a relatively rapid recovery from the second half of 2001, setting the framework for an uplift in world trade and investment. These changes in economic activity and expectations add complexity and uncertainty to developments in the year ahead.

In summary:

- The New South Wales and Australian economies are less vulnerable than North America to being tipped into a recession and should recover momentum during 2001-02.

- Outcomes in the labour market, however, are likely to reflect the lagged effect of the 2000-01 economic slowdown.

- Falling inflation is likely to allow interest rates to remain lower on average than in the preceding year.

- While aggregate output growth is expected to strengthen in 2001-02, the composition of growth is likely to shift away from net exports (due to subdued overseas markets) towards domestic demand (reflecting a recovery in dwelling construction in particular).

- The New South Wales economy, which is relatively less exposed to export fluctuations and more reliant on domestic demand than the national economy, is expected to perform close to the national average during 2001-02.

Table 1.7: Economic Performance and Outlook[(a)]

	Outcomes 1999-2000	Estimates 2000-01	Forecasts 2001-02
New South Wales			
Gross State Product	3.7	2	2 ¾
State Final Demand	5.8	¼	3 ¼
Employment	3.2	1 ¾	¾
Unemployment rate[(b)]	5.8	5 ½	6 ¼
CPI (Sydney)	2.4	6	2 ¼
Wages[(c)]	3.0	3 ¾	3 ½
Australia			
Non-farm GDP deflator	1.8	3 ¾	3
Ten year bond rate[(b)]	6.5	5 ½	6

Source: Australian Bureau of Statistics; New South Wales Treasury.

Notes: (a) Year average percent change, unless otherwise indicated.
(b) Year average, percent.
(c) Wage Cost Index, ordinary time pay, New South Wales.

Growth of ***private consumption*** in New South Wales is forecast to strengthen modestly in 2001-02. Although household income growth is likely to be more moderate and higher unemployment is likely to constrain consumer sentiment, spending nonetheless is likely to be boosted by declining interest rates and expectations of improved economic conditions ahead.

Dwelling construction in New South Wales fell sharply in 2000-01 due in large part to the transition to new national tax policies. Nonetheless underlying demand appears to remain strong, as reflected in the buoyancy of house prices. Reduced interest rates together with first home owner incentives from the State and Commonwealth Governments appear to be boosting affordability. Therefore dwelling construction is likely to have reached a trough in the second half of 2000-01 and is expected to recover by around 10 percent in 2001-02, albeit from a low base.

Machinery and equipment investment is expected to decline somewhat in 2001-02 mainly reflecting slower information and communications technology (ICT) investment. Since most ICT equipment is foreign sourced, reduced imports would directly offset the impact on GSP from lower investment. ***Non-residential construction*** on the other hand, with higher domestic content, is likely to undergo a mild recovery after steep falls in the preceding year. Overall, business investment in New South Wales is forecast to be fairly stable in 2001-02.

New South Wales ***employment growth*** in year average terms is expected to ease to ¾ percent in 2001-02 from 1¾ percent in 2000-01, as implied by subdued leading indicators such as the ANZ Job Advertisements series. However employment growth should strengthen through the year as demand recovers in the construction sector and more generally across the economy.

The more subdued pace of employment growth is likely to exert some mild upward pressure on the ***unemployment rate*** which is forecast to rise from an average 5½ percent in 2000-01 to 6¼ percent in 2001-02, but remain below the national average.

Wage cost growth is expected to ease slightly to 3½ percent in 2001-02, reflecting more subdued conditions in the labour market and greater post-GST stability in the cost of living. Award wage increases available under the May 2001 national Safety Net Decision remain modest. While trends in federal enterprise bargaining agreements strengthened slightly during 2000, labour market conditions ahead are not expected to sustain further acceleration.

Sydney ***consumer price inflation*** is forecast to ease from 6 percent in 2000-01 to 2¼ percent in 2001-02 with the unwinding of the one-off impact of the GST and the delayed impact of slower economic growth in the preceding year. Moderating crude oil prices in response to slower world growth plus a likely appreciation in the Australian dollar also are expected to help reduce pressure on inflation.

Given expectations of a modest recovery in economic growth in 2001-02 and in view of the 1¼ percent reduction in official interest rates during the first half of 2001, any further easing of monetary policy is assumed to be slight. Long bond rates are likely to maintain their recent values with markets anticipating the reversal of the economic downturn and increased demand for investment capital further ahead.

MEDIUM TERM OUTLOOK

Prospects for the economy throughout the period beyond 2001-02 will depend on trends in world output, the business cycle and domestic policy settings. Because these factors cannot be predicted with any precision more than a short period ahead, the budget estimates beyond 2001-02 are based on economic parameters determined by expectations for their average performance this decade.

The medium term parameters for output, employment and population are consistent with historical performance and with demographic projections by the Australian Bureau of Statistics, and reflect currently observable trends. Expected average population growth has been revised down since the last Budget, and this necessitates a downward revision to expected average employment growth and consequently to GSP growth. Growth on a per capita basis is unchanged. Medium term assumptions for prices and wages reflect public statements by the Reserve Bank of Australia as to their policy objectives.

Table 1.8: Economic Parameters Beyond 2001-02[(a)]

	Medium Term
Gross State Product	3
Population	1
Employment	1
CPI (Sydney)	2 ½
Wages [(b)]	4
Ten year bond rate[(c)]	5 ¾

Notes: (a) Year average percent change, unless otherwise indicated.
(b) Wage Cost Index, ordinary time, New South Wales.
(c) Year average yield, in percent, on Commonwealth Government ten year bonds.

MAJOR RISK FACTORS

The economic outlook remains clouded by considerable uncertainty, as the economy faces up to its second major test since the 1991 recession (the first being the 1997-98 Asian financial crisis). Uncertainty is compounded because current trends have been obscured by the transitional distortions resulting from the GST and the 2000 Olympics. Major risks and uncertainties (all of which are *possible* but not *assumed*) include:

(a) Developments which might detract from growth:

♦ The US economy is undergoing a very sharp deceleration, with steep falls in share markets, industrial production, and business and consumer confidence. The correlation between US and Australian performance has been close historically, but it is neither automatic nor inevitable for the future. While the forecasts allow for the possibility of a shallow US recession, they do not make provision for a deeper recession in the US flowing on to the local economy;

- The projected upturn in the New South Wales construction sector may not emerge as rapidly or as strongly as expected; and

- Business confidence in 2001-02 may not recover as quickly as expected.

(b) Developments which might add to growth:

- The recovery in world growth may prove stronger and more durable than anticipated. This could rekindle growth in asset markets and investment while putting upward pressure on prices and interest rates; and

- A shift to expansionary monetary and fiscal policy, together with a favourable evolution of external conditions may lead to an overcorrection upwards in business and consumer behaviour.

A guide to the significance of these risk factors is provided in Section 2.6, which assesses the sensitivity of the Budget net lending to alternative economic scenarios.

Box 1.3: Possible Economic Outcomes

The forecast for the New South Wales and Australian economies for the remainder of the current and next financial year is for continued growth at a somewhat slower pace than in the previous three financial years. That deceleration is largely the result of a short downturn in residential and non-residential building and slower growth of business investment in machinery and equipment against a background of a softer global economy.

The forecasts are influenced by the information available at the time they were made, information that largely applies to some period in the past. As additional information becomes available it may suggest that a somewhat different outcome is more likely. That, of course, is an unavoidable source of risk for forecasts which involve anticipating what will happen in the future based on limited and dated information.

One possibility that was considered in making forecasts for 2001-02 is that of the world sliding into a significant recession as happened in 1990-91. If that were to happen, growth in output and employment in Australia would be lower than forecast and unemployment would be higher. On the basis of the information available towards the end of 2000-01, however, this is not the most likely of the possible outcomes.

Even if that worst case scenario were to occur, however, the domestic economy would not suffer a recession of the magnitude of that of ten years ago. Economic conditions in Australia, and for that matter in the rest of the world, are far different from 1990-91. Because of those differences, any economic slowdown would be much milder than a decade ago.

One major difference is that inflation is low and there is no overhang of excessive wage increases weighing down employment growth. Furthermore, interest rates are far lower than they were at the beginning of the last recession. As a result dwelling construction will almost certainly rebound much more quickly.

As the economy moved into recession ten years ago, there was a very large surplus of office space in all Australia's capital cities, including Sydney. Office vacancy rates were as high as 30 percent, compared to around 5 percent in March 2001. There was also surplus capacity in shops, factories and other business premises. Resumption of new construction had to wait five years until that excess of space had been absorbed.

Also in 1990-91 Australian banks, like banks around the world, were carrying a load of bad debts so large that the continued existence of some banks was threatened. To help restore their balance sheets, banks stopped lending, meaning those companies that did want to build and invest were starved of finance. We do not have an equivalent situation today.

A final difference with the previous recession is that at that time the $A was above $US0.75. Today, the $A is close to $US0.50. Australia's exporters are much more competitive than they were in the previous recession. Australia's exports will not be impervious to a world recession but they will hold up better than they did in the previous recession.

For the reasons outlined above, if the world does slip into recession, growth will not fall as far as it did a decade ago, nor will unemployment rise as far.