Treasurer of New South Wales
Australia

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STATEMENT BY HON. MICHAEL EGAN MLC

THE CARR GOVERNMENT'S NEW FISCAL STRATEGY: A PLAN FOR A SECURE FUTURE

NSW Treasurer Michael Egan said today that the key objectives of the Carr Government's 1995 General Government Debt Elimination Act had now been effectively achieved, fifteen years ahead of schedule.

Mr Egan said the Government's mid-year financial report, which will be finalised and released before Christmas, would show:

- the actual general government net debt was now less than zero; and
- the underlying general government net debt at just one per cent of the State's annual economic output or Gross State Product.

Mr Egan said the elimination of debt had not been pursued for its own sake.

"It was pursued for two very practical purposes.

"The first was to divert taxpayers' dollars from paying the annual interest bills to funding improved services and infrastructure.

"Our annual funding of new infrastructure has now reached $7.5 billion per year - $3.6 billion in the general government sector and $3.9 billion in the public trading enterprises.

"In real terms this level of infrastructure spending is almost 33 per cent larger than the average of the nineties – 66 per cent larger than the eighties, and over double that of the seventies.

"Funding of recurrent services has also increased substantially over the last ten years, with increases of 88 per cent in health funding, 77 per cent in education funding, 84 per cent increase in police and community safety funding and 85 per cent in transport and road funding.

"These large and sustainable funding increases have been assisted, to a significant extent, by the billion dollars a year that we are now saving on the State's annual interest bill.

"The second purpose of reducing debt was to shock-proof the State from adverse financial events – shocks that cannot necessarily be predicted, but are inevitable from time to time.

"The real test of any government's finances comes when unfavourable events hit – for example, when revenue weakens because of a recession or a property market downturn.

"Our basic fiscal strategy has been to strengthen the State's finances so that the steady growth of service delivery and infrastructure provision can be maintained in the face of fluctuations in revenue growth.

"That has meant reducing general government debt and other liabilities so that we can absorb temporary financial shocks without triggering the need for economically and socially disruptive fiscal responses."

Mr Egan said that the credit rating agencies had recognised New South Wales' strong financial position and continue to award NSW the highest credit rating (AAA).

Last month, Standard and Poors, said:

> "any change to the rating would require several years of much weaker financial outcomes than currently forecast, combined with government inaction in addressing fiscal problems. Standard and Poor's views either of these scenarios as highly unlikely."

Moody's also reaffirmed their highest rating for New South Wales (January 2004), stating that:

> "The stable rating outlook reflects the state's strong fiscal record and modest debt burden, which affords it considerable financial flexibility. While the potential for more slowly growing revenues could complicate the state's financial performance over the medium-term, NSW is well positioned to face these challenges given its low debt burden and strong financial management."

THE NEED FOR NEW FISCAL TARGETS

Mr Egan said that the achievement of the targets in the General Government Debt Elimination Act now made it necessary to re-set the fiscal policy compass.

"In doing so, the Government will be guided by two principles."

"The first is to maintain a sound medium-term financial framework for sustainable delivery of service and infrastructure improvements.

"And the second is to prepare the State's finances for the pressures that will come in the longer term, so that we can maintain service delivery for an ageing population.

Mr Egan said that the NSW Government's submission to the Productivity Commission's Study into the economic implications of an ageing Australia (copy attached) had highlighted the pressures ahead.

"Over the next forty years, the proportion of the population aged over 64 years will rise from 13 per cent in 2002 to 25 per cent in 2041.

"The total dependency ratio (that is the proportion of the population aged either under 15 or over 64) is expected to rise from 33 per cent to 40 per cent.

"Put simply, NSW, like all other states, faces major future costs for health, social services, housing and transport, while having a smaller proportion of its total population in the workforce to pay for them.

"Just as today's thirty or forty year-olds must plan and prepare for their personal financial position thirty and forty years ahead, so too must the Government.

"That's why it is essential, notwithstanding our success in meeting the targets of the Debt Elimination Act, to set out a new longer-term fiscal strategy and targets.

"Up till now, reducing net debt has been the focus because debt is a burden that cannot be deferred.

"Just like a household mortgage, interest payments on debt must be paid on a regular basis. It is for this reason that debt is the burden most focussed on by credit rating agencies.

"With general government debt not now an issue, the focus of fiscal strategy can change to the broader concept of net financial liabilities.

Net financial liabilities are the difference between the level of financial assets, such as cash, advances and investments, and total financial liabilities. Net financial liabilities comprise net debt, unfunded superannuation liabilities, insurance liabilities, and other liabilities (mainly represented by accrued employee entitlements, such as long service leave).

THE NEW FISCAL TARGET

The Government's new fiscal target will be to reduce total general government net financial liabilities to 5 per cent of Gross State Product.

The target date will be announced in next year's Budget, but will be based on 2020 under existing accounting standards.

However, the 2005 NSW Budget, and the budgets of all other Australian jurisdictions, will be based on the new international accounting standards.

Based on current accounting standards, the State's current general government net financial liabilities are 8.7 per cent of GSP (compared with 20 per cent of GSP at June 1995, also based on current accounting standards).

Based on the new international accounting standards, the net financial liability figures will be greater for both the current and past years.

MEASURING THE BUDGET RESULT

There are three measures of the net financial result of the government's operations each year:

- The net cash result;
- The net lending or borrowing result;
- The net operating result.

Each of them, in a different way, measures the differences between the government's expenditures and revenues, and can therefore show a surplus, a deficit or a balanced budget.

The net cash result has fallen into disuse with the advent of accrual accounting, although it is still the measure favoured by the Commonwealth government.

None of the three measures is right or wrong. They serve different purposes, and which one deserves emphasis depends on which is the best gauge of the government's progress towards its fiscal objectives.

Each measure is reported in the New South Wales budget papers, mid-year budget review, and final budget outcome report, and will continue to be.

Up till now, the NSW Government has highlighted the most stringent measure – the net lending or borrowing result – because of our determination to unshackle NSW citizens from an accumulated and costly general government debt burden.

Now that has been achieved, and in view of the continuing actual cash surpluses that are projected, NSW, like most other States, will now emphasise the net operating result.

The net operating result measures the difference between each year's revenue and the government's use of resources in that year.

In essence it tells you whether the year's budget operations are adding to or subtracting from the State's net worth.

A deficit means you are eating into your assets to fund the year's consumption. A surplus means you are paying for the resources you consume and are building up net worth.

Except in extraordinary circumstances, the net operating result should, on average, always remain in surplus. When it does, it means that the State's general government sector is becoming financially stronger. If it doesn't, it means that the State is financially going backwards.

The Government's aim, therefore, will always be to achieve a strong net operating surplus.

The appropriate size of that surplus will always be sensitive to the revenue cycle and will be kept large enough to meet the objectives of keeping net financial liabilities on a downward path towards 5 per cent of Gross State Product and enabling the Government to fund a high and growing infrastructure program.

Mr Egan said that over the past six years (to 2003-04) only NSW and Victoria had consistently achieved significant operating surpluses.

NEW FISCAL RESPONSIBILITY LEGISLATION

The General Government Debt Elimination Act will need to be replaced with legislation that gives expression to the updated fiscal strategy.

The Debt Elimination Act has been a success. It helped NSW to make the transition to the very strong financial position we see today.
A new *Fiscal Responsibility Bill* will be introduced in the Budget session 2005.

Many provisions of the Debt Elimination Act remain relevant and will be retained, but others will need to be changed to reflect the new emphasis on net financial liabilities and the net operating result.

ATTACHMENT "A"

International Accounting Standards

The exact quantification of the fiscal targets will need to be finalised in the early part of 2005, taking into account the adoption of new international accounting standards (IAS) for financial reporting periods commencing on or after 1 January 2005 (for the commencing 1 July 2005 for the NSW Public Sector).

Even though there will have been no change in the State's underlying fiscal position, the new accounting standards measure some items differently, and result in some changes to budget aggregates.

Technical accounting adjustments will mean that some liabilities will be recorded at higher levels and expensed at higher rates – even though there will be no change to service deliveries, cash payments to fund those liabilities or the structural position of the government's balance sheet.

For the General Government Sector, the major impact will be an initial increase in the liability for unfunded superannuation, and increased volatility of both the superannuation expense and superannuation liability in future years.

Up until now, superannuation liabilities have been valued on the same basis as the earnings on our superannuation assets.

This is an actuarially-forecast rate based on historical market performance – currently 7.3 per cent – which gives a real and accurate picture of liabilities.

The new accounting standards require us to use the bond rate – currently 5.2 per cent – to value the State's superannuation liabilities, which has the effect of increasing the reported present day value.

But because the superannuation assets will still be earning market returns, while the unfunded liability will initially appear larger, it will be expensed more quickly and we will still meet our target.

It should be emphasised that the changes resulting from the adoption of new international accounting standards for superannuation will not result in the budget paying one additional cent in superannuation.

The other potential impact for the General Government Sector will be increased volatility in dividends and taxes received from the Public Trading Enterprise Sector.

This will flow from an increased volatility of accrual-based profits in the PTE Sector.

Volatility in PTE profits will arise from fluctuations in their unfunded superannuation expense and increased volatility arising from the amended treatment of financial instruments.

The possible effects of the new accounting standards are still being evaluated, but will significantly raise the level of net financial liabilities.

This in turn will have to be taken into account in framing the Government's fiscal strategy targets. In particular, the target date of reducing net financial liabilities to 5 per cent of GSP by 2020 will need to be recalibrated once the effect of the new accounting standards is known.

ATTACHMENT "B"

Achievement of the General Government Debt Elimination Targets

The Government's fiscal strategy encompassed a number of principles and targets – set out in the General Government Debt Elimination Act of 1995.

- The short-term target of a sustainable general government surplus by 1998-99 has been achieved with cash surpluses since 1996-97.
- The medium-term target of reducing general government net debt to a sustainable level by June 2005 has been achieved ahead of schedule.
- In fact, general government net debt has now been eliminated according to the internationally accepted Government Finance Statistics (GFS) definition used by the Australian Bureau of Statistics.
- However, the Government also reports "underlying net debt", which adjusts for the impact of payments into the Liability Management Fund that have been made in place of government contributions to superannuation since 2002-03. On this measure net debt has fallen from $12.1 billion at June 1995 to $2.6 billion at June 2004.
- The long-term target of eliminating general government net debt by 2020 has been achieved according to the GFS measure well ahead of schedule. On the "underlying" measure, it has been virtually achieved, at less than 1 per cent of GSP.
- The long-term target of eliminating total state sector unfunded superannuation liabilities by 2030 is also on track. Under the actuarially determined funding plan, the unfunded liability will remain around its currently level until 2013, and then decline until it is eliminated by 2030.
- The goal of maintaining general government net worth in real terms remains on track – with net worth increasing by an average of 7 per cent per annum in real terms from $79,655 million in June 1997 to $127,386 million in June 2004.

Although not specified as a legislative fiscal target, net financial liabilities for the general government sector have been reduced from $32.8 billion or 20 per cent of GSP at June 1995 to $24.7 billion of 8.7 per cent of GSP in June 2004 (both 1995 and current net financial liabilities are measured on the basis of current accounting standards).

<u>ATTACHMENT "C"</u>

Debt financing of public infrastructure

The total NSW public sector is analysed in the accounts in two sectors:

- First, the General Government sector. This sector consists of those agencies that are largely dependent on direct budget funding and which provide essential public services. The General Government sector includes *social* infrastructure in health and education and in police and corrective services.

- Second, the Public Trading Enterprise sector. This sector consists of government businesses that are not largely dependent on the budget. They have their own revenue sources through fees or user charges and they provide *economic* infrastructure. Electricity, water and public transport are in this sector. The fees and user charges may only partly cover costs (as in public transport).

The two sectors are funded in a different way.

- For the General Government sector, assets are mainly funded by taxation revenue. These assets do not earn a financial return, though they do of course have social returns. In the General Government sector, debt financing is avoided as the cost of servicing debt (interest payments) simply diverts resources away from immediate service delivery. A dollar paid out in interest is a dollar not paid out in service delivery. Further, demand for assets is, in aggregate across the General Government sector, rather constant in growth every year. It is not "lumpy" in aggregate and the growth trend is steady. There are variations year by year between the components of the aggregate, say in health, education and police – but in aggregate each year the infrastructure requirements are reasonably steady in growth terms.

- The Public Trading Enterprise sector is able to earn market returns (usually regulated) on its assets, and its revenues are derived from user charges or fees paid for the goods or services delivered. In these enterprises debt service charges can be covered by fees or user charges. The Public Trading Enterprises often have "lumpy" infrastructure demands. Electricity for example has major demands every decade or so and we are currently in the midst of a build-up to spend major amounts on public transport. There is a case for debt financing in this Public Trading Enterprises sector and indeed prudent debt levels provide commercial disciplines.

For this reason, the NSW fiscal strategy treats these two sectors differently:

- For the General Government sector, the *General Government Debt Elimination Act* sets a zero net debt target, which has now been achieved.

- The *Debt Elimination Act* sets no cap on debt for the Public Trading Enterprises sector, recognising that it is appropriate for this sector to carry levels of debt commensurate with prudent commercial behaviour and market conditions. <u>In fact, in the 2004-05 Budget Public Trading Enterprises are forecast to increase their net debt by $6 billion over the four years to 2007-08 to partly provide for $15.5 billion of capital investment, mainly in the public transport, water supply and electricity sectors.</u>